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FINANCE FORUM

Cadwalader Finance Forum

October 9, 2018

The Ritz-Carlton

Charlotte, NC

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Financing the Financiers – Trends in CRE Warehouse and Repo Finance

Stuart Goldstein

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Financing the Financiers – Trends in CRE Warehouse and Repo Finance

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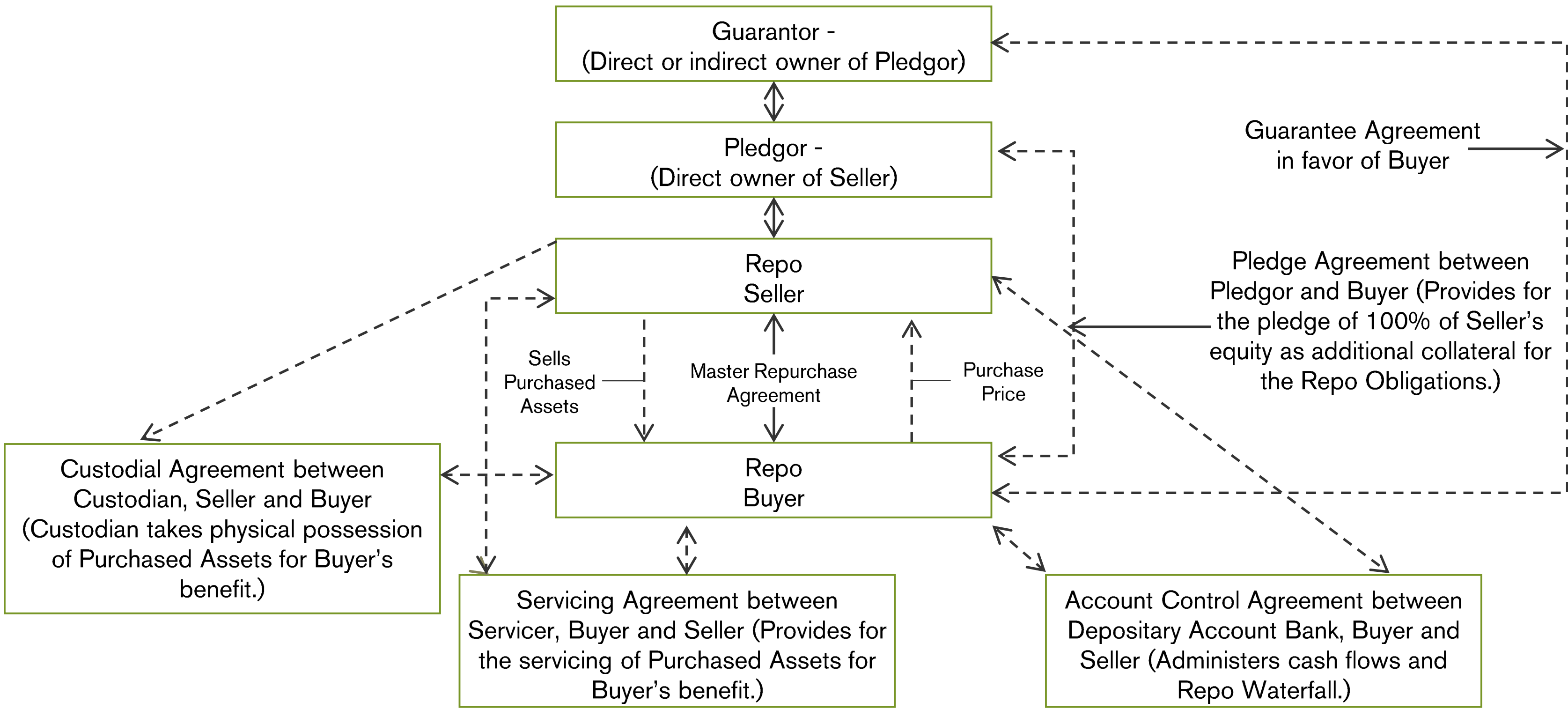
What is a Repurchase Agreement?

- A lending arrangement documented as a sale and buyback transaction
- Buyer agrees to purchase commercial real estate loans or a portfolio of commercial real estate loans from a Seller
- Seller agrees to pay price differential on a monthly basis
- Seller agrees to repurchase the loans on the repurchase date against repayment of the purchase price of the loan, plus accrued and unpaid price differential, plus any other fees and expenses due and payable to Buyer.

Structure Chart for a Typical Master Repurchase Agreement[1]



[1] Seller's counsel provides legal opinions on enforceability of Repo Documents, validly granted and perfected security interest and Bankruptcy Code Safe Harbor.

Pricing

- Buyer purchases the loans at a discount off the market value of the loan, which provides over-collateralization
- Buyer charges an interest rate on the aggregate purchase price of the loans, called "Price Differential"
- Since Buyer owns the assets (subject to the Seller's repurchase rights and obligations), following a default Buyer can realize on the loans and sell/dispose of them
- There is a risk that the transaction could be recharacterized as a loan, instead of a repo. In practice, repo Buyers are still advised to sell collateral in compliance with Article 9 of the UCC

Bankruptcy Safe Harbor Protection

- Safe harbor protection against the automatic stay in bankruptcy
  - Repurchase Agreement Safe Harbor
  - Securities Contract Safe Harbor
- Legal opinions are required on the availability of the safe harbor to the transaction and the assets.

Buyer Mark-to-Market Rights

- Buyer allowed to determine the market value of the loans on any business day
- If the market value of a loan is less than the product of the advance rate on that loan multiplied by the purchase price of the loan, a margin deficit exists
- Buyer is allowed to call margin to rebalance the advance on purchase price to the market value of the loan

Documentation

- Master Repurchase Agreement
- Custodial Agreement
- Pledge Agreement
- Guaranty Agreement
- Account Control Agreements
- Servicing Agreement

Benefits of a Repo Versus a Secured Lending

- Why a Repo instead of a secured financing?
  - Buyer incurs less market exposure in the case of Seller's bankruptcy if Buyer has the ability to immediately terminate and liquidate the forward repurchase transaction (as opposed to being a secured creditor in a bankruptcy proceeding)
  - Assets not subject to automatic stay in bankruptcy
  - Buyer gets mark-to-market rights on a daily basis

Recharacterization Risk: What is it?

Recharacterization Risk

- The risk that a sale under a Repo will be recharacterized by a bankruptcy court as a financing/loan.
  - Bankruptcy Courts have an equitable right to "recharacterize" a transaction.
  - ". . .the bankruptcy court is permitted to look beyond the form to the substance of a transaction in order to determine the true nature of a transaction as it relates to the rights of parties against a debtor's estate." See In re. Corporate Financing, Inc. et al 22 BR 671, 672 (E.D.N.Y. 1999)

Recharacterization: Mitigating the Risk

- Certain aspects of the transaction pose recharacterization risk:
  - Buyer retains recourse against the Seller with respect to the loans
  - The repurchase price reflects an implied interest rate
  - The Buyer advances less than fair market value to “purchase” the loans

Mitigating the Risk — Perfection

- Repurchase Agreement contains a back-up grant of a security interest
- Buyer (or, most likely, a Custodian on behalf of Buyer) has possession of the Mortgage Note as well as a full set of assignment documents, in blank, signed by the Seller
- UCC-1 Filing
- Possession of the Mortgage Note ensures priority in the related loan.

Recharacterization Risk: Why Does it Matter?

- If a court recharacterizes the transaction, the Buyer will be reduced to a secured creditor.
- The Buyer will be stayed from exercising remedies until the bankruptcy court resolves the bankruptcy filing, during which time, the assets may decline in value.
- “Owners” and “secured creditors” have very different rights in the assets.

Representations and Warranties

- Typically two types
- Seller level representations (corporate housekeeping, financial covenants, etc.). Breach of reps is an Event of Default.
- Asset level representations
- Remedy for a breach of asset level representations and warranties
  - asset value is reduced to zero
  - Seller must repurchase the asset for the full Repurchase Price

Covenants and Events of Default

- Financial Covenants
- Restrictive/Negative Covenants
- Affirmative Covenants
- Types of Events of Default
- Cure Periods
- Remedies

Conclusion: Advantages of Repo Structure

Advantages:

- Structure suitable for various commercial real estate loans
- Seller: Allows better pricing and flexibility
- Buyer:
  - Alternative to lending, less bankruptcy risk due to availability of the bankruptcy safe harbor
  - Allows for mark-to-market to mitigate market volatility risks
  - May allow for quicker and easier foreclosure as Buyer owns the loans outright and has mechanisms in place for quick enforcement, BUT Buyer has to be mindful of recharacterization risk when exercising remedies.

You Say Goodbye (LIBOR), I Say Hello (SOFR)

Jeffrey Nagle

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You Say Goodbye (LIBOR), I Say Hello (SOFR)

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PANELISTS

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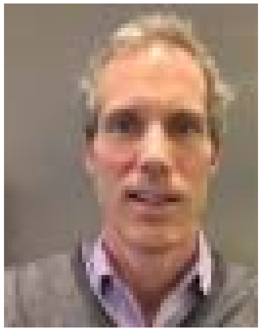

Spencer Langston
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Lary Stromfeld
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TOPICS

- Why LIBOR is going away?
- SOFR (what and why?)
- Transition for Derivatives
- Transition for Loans
- Transition for Floating Rate Notes (FRNs)

Why LIBOR is Going Away

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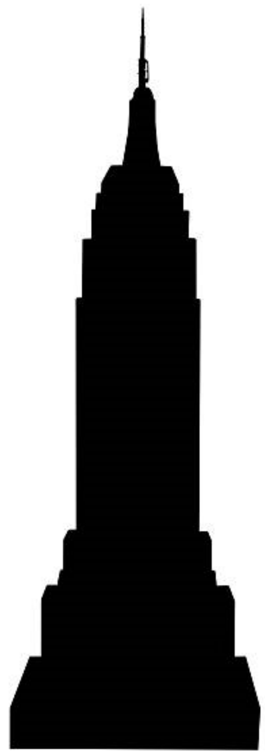
LIBOR: The Key Issues

- LIBOR may cease after the end of 2021 (or sooner)
- This is a challenge for the $200T+ of USD LIBOR-based contracts
- SOFR – the Secured Overnight Financing Rate (a Treasury repo rate) – is the replacement for swaps; it may be the replacement for loans, fixed rate notes and other products
- SOFR is very different than LIBOR, and this will require some adjustment
- There are many things that many markets, including the loans, CLOs, swaps, securitization and other markets, should be thinking about – and solving – by end-2021

The Size of the LIBOR Market

As of 2016, global market exposure to USD LIBOR was approximately <u>$200 trillion</u>…

…roughly <u>10x</u> U.S. Gross Domestic Product (GDP)



Empire State Building

Guggenheim Museum

The Fundamental LIBOR Problem

$200 TRILLION OF LIBOR BASED CONTRACTS

- There are more than $200T of USD LIBOR contracts outstanding
  - There is ~$500M of daily 3M $LIBOR trades, which are the basis for creating the LIBOR curve
    - This creates huge reliance on a small, fragile and potentially shrinking base rate

Priced off $500 million of daily Interbank (LIBOR) trading

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THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Estimated USD LIBOR Market Footprint by Asset Class(1)

		Outstanding Volume (USD Billion) Year End 2016	Year End 2021
Over-the-Counter Derivatives	Interest rate swaps	$81,000	$27,540
	Forward rate agreements	$34,000	$0
	Interest rate options	$12,000	$4,200
	Cross currency swaps	$18,000	$2,160
Exchange Traded Derivatives	Interest rate options	$34,000	$340
	Interest rate futures	$11,000	$110
Business Loans(2)	Syndicated loans	$1,500	$255
	Nonsyndicated business loans	$800	$112
	Nonsyndicated CRE/Commercial mortgages	$1,100	$187
Consumer Loans	Retail mortgages(3)	$1,200	$516
	Other Consumer loans	$100	$100
Bonds	Floating/Variable Rate Notes	$1,800	$288
Securitizations	Mortgage-backed Securities (incl. CMOs)	$1,000	$430
	Collateralized loan obligations	$400	$296
	Asset-backed securities	$200	$90
	Collateralized debt obligations	$200	$104
Total USD LIBOR Exposure:		**$199,000**	**$35,820**

(1) Source: Federal Reserve staff calculations, BIS, Bloomberg, CME, DTCC, Federal Reserve Financial Accounts of the Unites States, G.19, Shared National Credit, and Y-14 data, and JPMorgan Chase. Data are gross notional exposures as of year-end 2016.

(2) Figures for syndicated and corporate business loans do not include undrawn lines. Nonsyndicated business loans exclude CRE/commercial mortgage loans.

(3) Estimated maturities based on historical pre-payment rates.

LIBOR Transition: Step One

Members of Alternative Reference Rates Committee (ARRC)

Members	Ex Officio Members
▪ AXA ▪ Bank of America ▪ BlackRock ▪ Citigroup ▪ CME Group ▪ Deutsche Bank ▪ Fannie Mae ▪ Federal Home Loan Bank of New York ▪ Freddie Mac ▪ GE Capital ▪ Goldman Sachs ▪ Government Finance Officers Association ▪ HSBC ▪ The Independent Community Bankers of America ▪ Intercontinental Exchange ▪ ISDA ▪ J.P. Morgan Chase & Co. ▪ LCH ▪ LSTA ▪ MetLife ▪ Morgan Stanley ▪ National Association of Corporate Treasurers ▪ Pacific Investment Management Company ▪ SIFMA ▪ TD Bank ▪ Wells Fargo ▪ World Bank Group	▪ Consumer Financial Protection Bureau ▪ Federal Deposit Insurance Corporation ▪ Federal Housing Finance Agency ▪ Federal Reserve Bank of New York ▪ Board of Governors of the Federal Reserve System ▪ Office of Financial Research ▪ Office of the Comptroller of the Currency ▪ U.S. Commodity Futures Trading Commission ▪ U.S. Securities and Exchange Commission ▪ U.S. Treasury Department

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Introduction to SOFR

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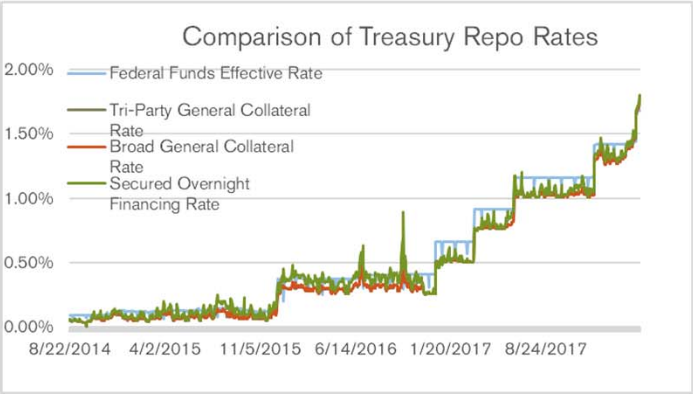
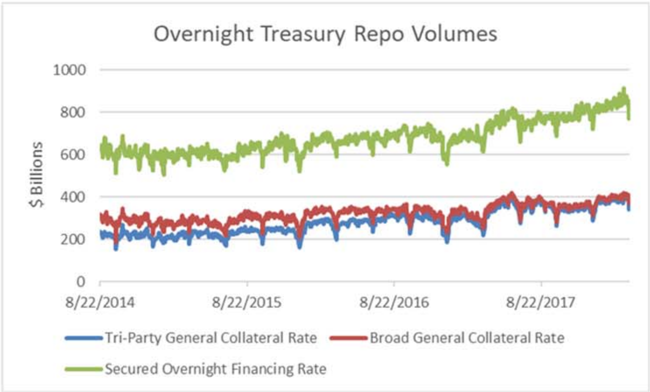
TOPICS

- SOFR is a broad measure of the cost of borrowing cash overnight against Treasury securities. It is administered by the Federal Reserve Bank of New York (FRBNY). It was launched in April 2018.
- Daily rates and volumes are available on the FRBNY website. (https://apps.newyorkfed.org/markets/autorates/sofr)
- The SOFR rate is based on transaction-level data from a tri-party repo clearing platform (BNY Mellon), general collateral financing ("GCF") data, and trimmed FICC-cleared bilateral Treasury repo transactions.
- There are significant volumes of SOFR. On average, the rate reflects about $675 billion funds borrowed.





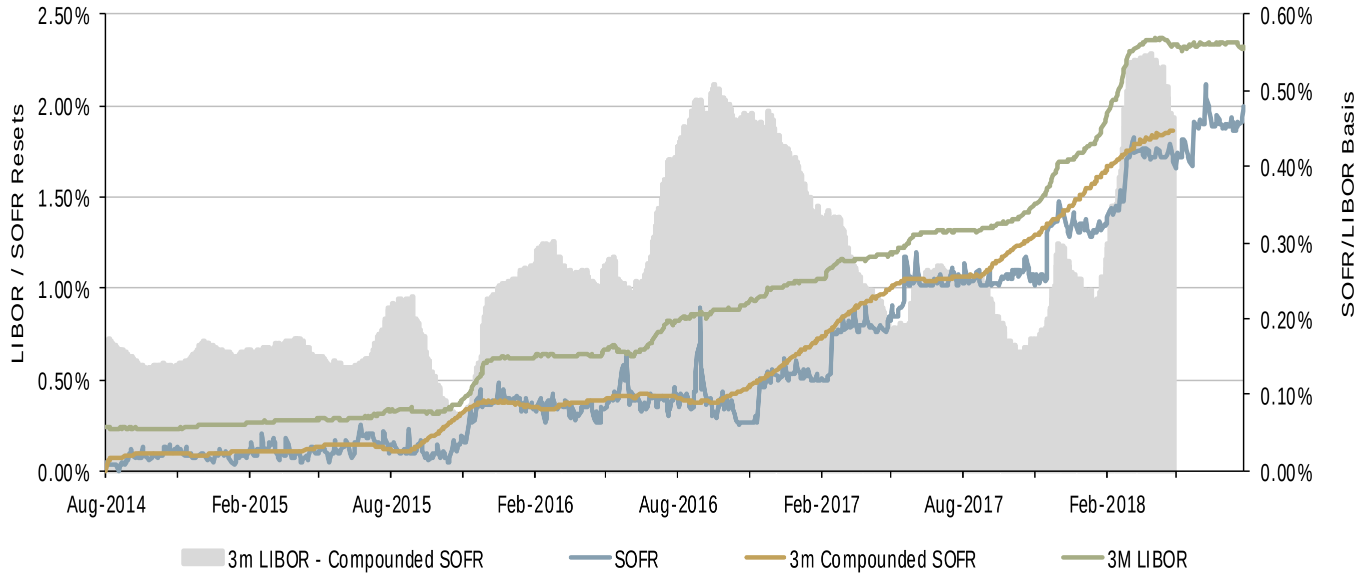
Source: Bloomberg; FRBNY

Comparison of LIBOR and SOFR

LIBOR	SOFR
ON, 1W, 1M, 2M, 3M, 6M and 12M maturities	Overnight (to begin)
Based upon few transactions	Based upon many transactions
$500 million of daily trading	Over $700 billion of daily trading
Published by ICE Benchmark Administration	Published by the Federal Reserve Bank of New York
Employs expert judgement	Based upon actual borrowing
Unsecured	Secured
Reflects bank cost of funds(ish)	Reflects the cost of borrowing against Treasury securities
Widens to reflect COF in stress periods	Will not widen in periods of credit stress
Established and well understood	Newly established rate
Linked to millions of long-dated derivative contracts	Linked to fewer contracts

Historical Spread Between LIBOR and SOFR

- FRB-NY formally began publishing SOFR in April 2018, but the Fed has provided historical data from 2014
- SOFR compounded over 90 days has average 25 bps lower than 3 Month LIBOR

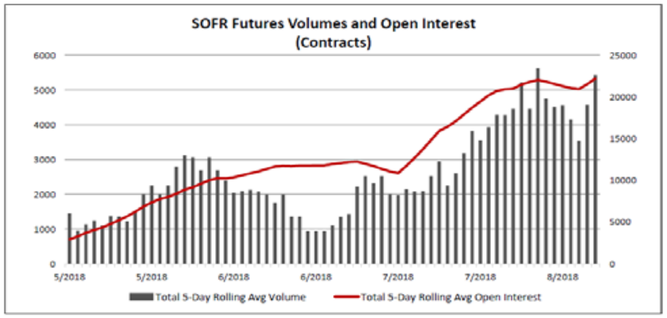


Recent Transactions

SOFR Swaps

Trade Date	Notional	Tenor	Non-SOFR Leg	Spread
7/16/2018	50,000,000	1 Year	Fed Funds	0.01%
7/16/2018	50,000,000	1 Year	Fixed	2.28%
7/17/2018	50,000,000	1 Year	Fed Funds	0.01%
7/19/2018	50,000,000	1 Year	Fed Funds	0.01%
7/23/2018	50,000,000	1 Year	LIBOR	-0.32%
7/24/2018	50,000,000	1 Year	Fed Funds	0.02%
7/30/2018	50,000,000	2 Year	Fed Funds	0.01%
8/1/2018	25,000,000	2 Year	Fed Funds	0.02%
8/8/2018	50,000,000	1 Year	Fed Funds	0.02%
8/13/2018	460,000,000	2 Year	LIBOR	-0.25%
8/13/2018	460,000,000	2 Year	LIBOR	-0.25%
9/26/2018	100,000,000	0.5 Year	Fixed	2.35%
10/1/2018	50,000,000	0.5 Year	Fed Funds	-0.04%
10/1/2018	50,000,000	0.5 Year	Fed Funds	-0.04%
10/1/2018	50,000,000	1 Year	Fed Funds	-0.04%

SOFR Futures



SOFR Swaps

Issuer Name	Size (mm)	Type	Maturity	Spread at Issuace
Federal National Mortgage Association	2,500	Senior Unsecured	1/30/2019	S+8
Federal National Mortgage Association	2,000	Senior Unsecured	7/30/2019	S+12
Federal National Mortgage Association	1,500	Senior Unsecured	1/30/2020	S+16
International Bank for Reconstruction & Development	100	Senior Unsecured	8/21/2020	S+22
Sheffield Receivables Co	525	ABCP Facility	11/28/2018	S+35
Credit Suisse AG/New York NY	100	CD	2/21/2019	S+35
Metropolitan Life Global Funding I	1,000	Senior Unsecured	9/7/2020	S+57
NY MTA	125	Senior Unsecured	6/26/2019	66% S+43
Wells Fargo Bank NA	1,000	Senior Unsecured	3/25/2020	S+48
Wells Fargo Bank NA	125	CD	9/20/2019	S+35

Transition for Derivatives

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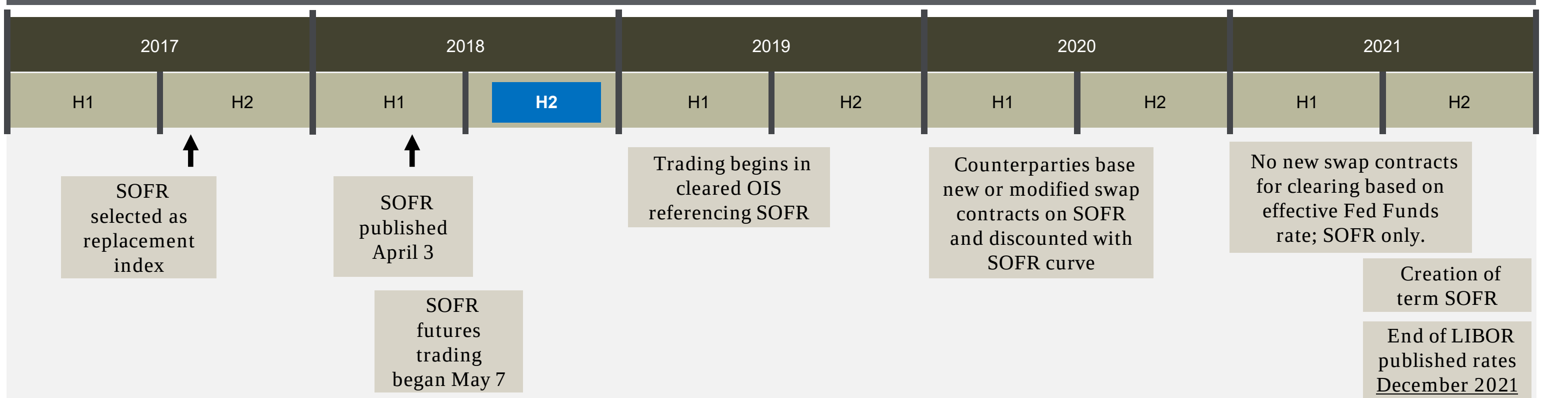
Transition Developments

Paced Transition Plan



ISDA Consultation

- July –Oct 2018, ISDA is conducting a market-wide consultation process pertaining to non USD IBOR (AUD, CHF, GBP, HKD, JPY).
- ISDA plans to make results of such protocol known by the end of 2018, and implement revised IBOR definitions in 2019.
- ISDA has indicated that they will conduct similar consultations regarding USD LIBOR and EUR LIBOR fallback to SOFR and ESTER in 2019.

ISDA Consultation regarding Fallback Rates

- The consultation makes clear several pertinent items:
  - Triggers contemplate a permanent cessation of IBOR as announced by the administrator or supervisor.
  - Fallbacks from IBORs are to the various approved alternative risk free rates (RBA, Saron, Sonia, Honia, TIBOR).
  - Implementation will be done through a protocol and in partnership with a vendor who can provide information to market participants about the fallback rates and spreads (e.g. a Bloomberg screen).
- The consultation solicits input about how to apply alternative reference rates in the event of a fallback .

Suggested Credit Spread Adjustments

- Forward Approach – calculated based on observed market prices for the forward spread
- Historical Mean/Median Approach – based on the mean or median spot spread between the relevant IBOR and RFR over [5 or 10] years.
- Spot-Spread Approach – based on the spot spread between the relevant IBOR and the RFR on the day preceding the announcement

Suggested Term Adjustments

- Spot Overnight Rate – the SOFR two business days prior to the beginning of the period
- Convexity-adjusted Overnight Rate – The Spot Overnight Rate, but compounded over the period
- Compounding Setting in Arrears Rate – the compounded average of SOFR observed over the period
- Compounded Setting in Advance Rate – Compounded in Arrears Rate referencing the prior period

Transition for Loans

Introducing the US$ Syndicated Loans Fallback Consultation

- What is LIBOR Fallback language?
  - It answers the question "If LIBOR ceased tomorrow, to what rate would my loan fall back?"
- What are the four components of LIBOR fallback language?
  - **Trigger** – What event precipitates a transition from LIBOR to the new reference rate? (An example of a trigger is LIBOR being discontinued.)
  - **Reference Rate** – What is the new reference rate for the loan? (For LIBOR-based loans, the new reference rate is most likely SOFR.)
  - **Spread Adjustment** – Because LIBOR and SOFR are different rates, there may need to be a spread adjustment to make them more comparable. What is the mechanism to determine that rate?
  - **Amendment Process** – Some variants of fallback language require amendments and votes.
- What are the ARRC's two proposals?
  - An "**Amendment**" Approach which is similar to the fallback language that has been introduced in syndicated loan agreements in the past year.
  - A "**Hardwired**" approach that anticipates the transition from LIBOR and sets all the terms for that transition at the origination of the credit agreement (thus avoiding the need for an amendment).

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The Amendment and Hardwired Approach have Same Five Mandatory Triggers

- Two triggers that reflect LIBOR cessation and match ISDA triggers for derivatives
- One trigger that signals an unannounced stop to LIBOR
- One trigger that signals a change in the quality of LIBOR due to insufficient submissions
- One trigger that reflects a regulator view that LIBOR is no longer fit for purpose

- *If any of these triggers occur, then both the Amendment and the Hardwired Fallback Approaches will begin the process to shift to a new reference rate*

The Amendment and Hardwired Approach have Similar Early "Opt-In" Triggers

- Loans are easily amendable
- A number of ARRC Working Group members saw value in the ability to amend to a new reference rate if it began being used in new or amended credit agreements
- The "opt-in" trigger could reduce the inventory of loans that might need to be converted upon LIBOR cessation
- Hardwired approach
  - [at least two] currently outstanding public syndicated loans in the United States at such time contain… term SOFR plus a Replacement Benchmark Spread, and
  - Required or Supermajority Lenders affirmatively consent to amendment
- Amendment approach
  - Administrative Agent or Required Lenders have determined that syndicated loans are being executed or amended to incorporate or adopt a new benchmark interest rate to replace LIBOR, and
  - Required lenders have affirmatively accepted amendment to replace LIBOR

Amendment Approach

- **Triggers** - Mandatory and Opt In triggers as defined previously
- **Replacement Reference Rate**
  - Alternate benchmark rate agreed between Borrower and Administrative Agent, considering term SOFR and spread adjustments
- **Spread adjustment**
  - Agreed to between Borrower and Administrative Agent, considering market convention and recommendation by Relevant Governmental Body
- **Amendment language**
  - Required lenders get objection rights (negative consent) for mandatory triggers

- *Differs from existing amendment language because it offers more specificity, specifically referencing SOFR, spread adjustments and negative consent rights*

Hardwired Approach

- **Triggers** - Mandatory and Opt In triggers as defined on previously
- **Replacement Reference Rate**
  - Term SOFR; if Term SOFR is not available, then Compounded SOFR; if Compounded SOFR is not available, then overnight SOFR; if overnight SOFR is not available, then switch to an "Amendment" approach, whereby borrower and administrative agent determine an alternate rate of interest.
- **Spread adjustment**
  - The LIBOR-SOFR spread adjustment selected, endorsed or recommended by the Relevant Governmental Body
  - If not available, then the spread adjustment selected by ISDA
- **Amendment**
  - If the replacement rate is pre-determined (i.e., term SOFR, compounded SOFR or overnight SOFR plus spread adjustment), then no amendment is required
  - If the pre-determined rate plus spread adjustment is not available, the hardwired approach falls back to an amendment approach. In this provision, required lenders have objection rights (negative consent)

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Transition for Floating Rate Notes

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Comparison of Syndicated Loan and FRN Fallbacks

Syndicated Loans (Hardwired)

Triggers:

- Two permanent cessation triggers (same as derivatives) and three additional pre-cessation triggers
- "Opt-in" Trigger based on other syndicated loans in the market

Replacement Benchmark Waterfall:

- Term SOFR -> Compounded SOFR -> Overnight SOFR.
- If none of the above, then Borrower and Administrative Agent agree on alternate rate of interest giving "due consideration" to prevailing market convention or rate selected by Relevant Government Body.

Spread Adjustment Waterfall:

- Spread adjustment selected by the Relevant Government Body
- Spread adjustment selected by ISDA

Floating Rate Notes

Triggers:

- Same five permanent cessation and pre-cessation triggers
- No "opt-in" or other triggers

Replacement Benchmark Waterfall:

- First three rates are the same (Term SOFR -> Compounded SOFR -> Overnight SOFR)
- If none of the above, then rate selected by the Relevant Government Body-> rate determined under ISDA definitions -> rate determined by issuer or its designee

Spread Adjustment Waterfall:

- Same as Syndicated Loans except that the ISDA spread adjustment only applies if the Replacement Benchmark is equivalent to the ISDA Fallback Rate
- If none of the above, spread determined by the issuer or its designee

Next Steps

- Consultations
- Include SOFR in new deals
- Participate in and listen to webcasts, podcasts
- Socialize with internal constituencies

Resource list:

- Alternative Reference Rates Committee Frequently Asked Questions
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Sept-20-2018-FAQ.pdf

- Alternative Reference Rates Committee Guiding Principles
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-principles-July2018

- ISDA Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW
https://www.isda.org/2018/07/12/interbank-offered-rate-ibor-fallbacks-for-2006-isda-definitions

- ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Issuances of LIBOR Floating Rate Notes
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-FRN-Consultation.pdf

- ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Syndicated Business Loans
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Syndicated-Business-Loans-Consultation.pdf

- Cadwalader Cabinet LIBOR and Indices Resource Page
https://www.findknowdo.com/content/libor-and-indices

Questions?

SASB Transactions: Lender, Borrower and Rating Agency Perspectives

Jessica Wong

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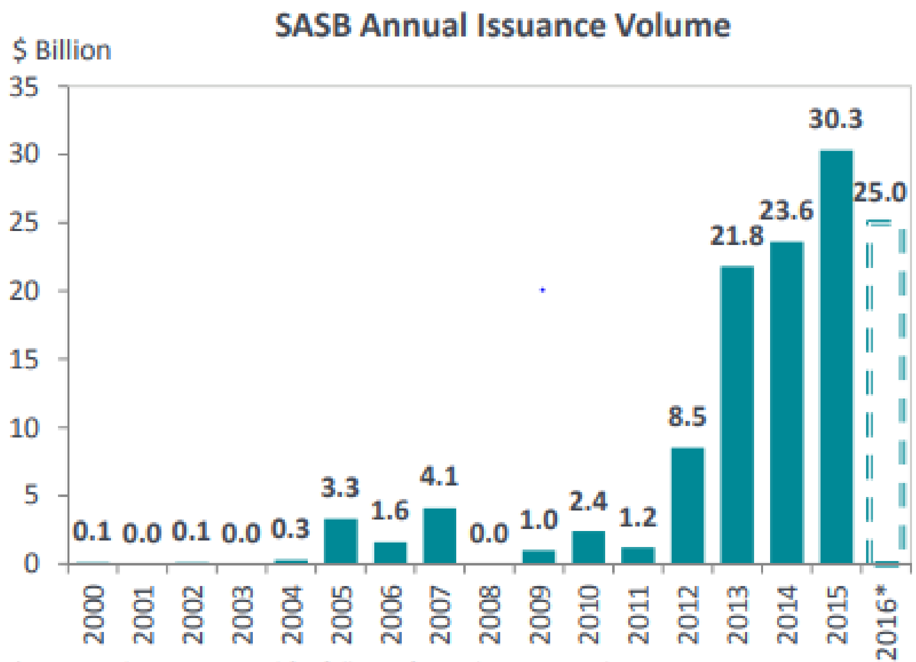
SASB LOANS

Single Asset Single Borrower ("SASB")

- One loan to a single borrower backed by one or multiple properties that are generally cross-collateralized and cross-defaulted.
- SASB transactions have been offered across all major property classifications throughout the United States. The properties that are collateral for such loans are generally located in urban markets with strong, institutional sponsorship.
- Ability to covert SASB loan into multiple CMBS classes of certificates to meet different investors' appetites and use of mezzanine loans to provide additional leverage.

RISE OF THE SASB MARKET

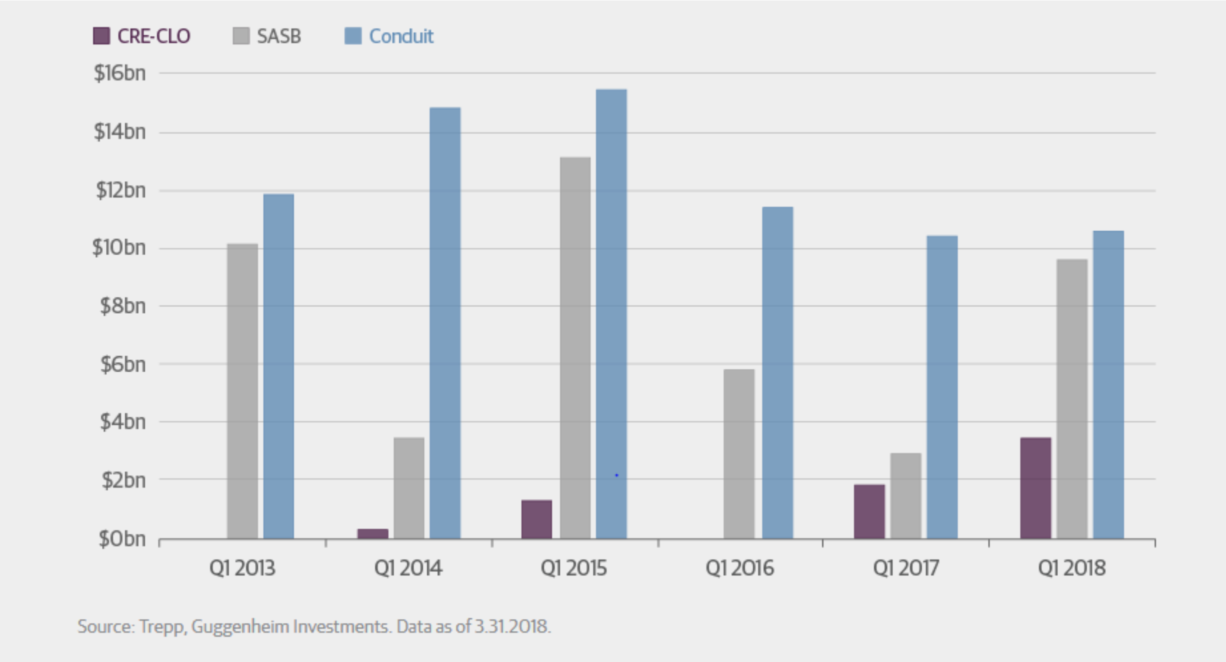
- Prior to 2009, SASB transactions had approximately $10 billion of issuance, in the aggregate, in the prior decade



* Estimated. Data reported for full year for each time period.
Source: BBH Analysis

OUTLOOK FOR SASB LOANS

- Through the third quarter of 2016, there were 24 SASB transactions totaling approximately $11.6 billion. Through the third quarter of 2017, SASBs nearly doubled to 43 transactions totaling approximately $25.3 billion.
- 88% of the 2017 SASB Loans were refinancings.
- SASB Deals increased 228% in the First Quarter of 2018



SASB LOAN CONSIDERATIONS

- Non Recourse Carveout Guaranties
- Transfers/Assumptions
- Multi-Property Transactions
- Ground Lease Financeability

NON-RECOURSE CARVEOUT GUARANTY

A. Recourse Carveout Guaranty

   i. SASB Real Estate Loans are typically non-recourse loans with SPE borrowers who have no assets other than the collateral for the Loan

   ii. Intended to protect Lender against certain bad acts or omissions by Borrower

   iii. Guarantor liability falls within two categories: (i) Lender's losses or damages for certain acts or omissions or (ii) the entire loan amount for certain egregious acts by Borrower or serious risks to the collateral for the Loan

B. Structural Considerations

   i. Determination of the creditworthiness of Guarantor

      - Net Worth and Liquidity Covenants

   ii. Loans without a deep pocket Guarantor

      - Foreign sponsors

   iii. Cap on liability of Guarantor

      - Liability of Guarantor, in particular for bankruptcy related carveouts, have been capped in the guaranty

TRANSFERS/ASSUMPTIONS

A. Transfer and Assumption Rights

   i. Many SASB real estate loans include the right for the Borrower to sell the property and the purchaser to assume the Loan subject to Lender consent and/or satisfaction of certain term and conditions

B. Qualified Transferee

   i. For loans that do not require Lender consent to an assumption, the loan documents often include the requirement that the transferee be a "qualified transferee" that satisfies certain eligibility requirements, which may include thresholds for net worth and assets owned and applicable commercial real estate experience.

C. Replacement Guarantor

   i. Upon a transfer of the Property and a loan assumption, most Guarantors seek to be released from liability under the Guaranty.

   ii. Existing guarantor should only be released upon delivery of replacement guarantor and only for obligations arising from and after the date of such assumption.

   iii. Replacement Guarantor is usually a creditworthy entity reasonably satisfactory to Lender or meets certain eligibility requirements in the loan documents.

MULTI-PROPERTY TRANSACTIONS

A. There have been an increasing number of SASB Transactions for a large portfolio of assets

    i. Recent SASB transactions have included the financing of the acquisition of portfolios of hotels by real estate investment trusts

B. Property Release Provisions

    i. Multi-property loans benefit from cross-collateralization and cross-default provisions

    ii. Borrowers often have the right to release certain individual properties subject to satisfaction of certain terms and conditions

    iii. Borrowers typically pay a release price of the allocated loan amount for such property plus a release price premium (i.e. 115% of such individual property's allocated loan amount)

LEASEHOLD FINANCING

Financable ground leases must contain certain provisions and characteristics, including:

A. Term

i. A ground lease with a short term remaining or which contains material conditions to extension can limit the refinancability of a leasehold loan.

ii. Options to extent may be counted, but such options should be exercisable in advance and permit the lender to exercise such extension on behalf of tenant.

B. New Lease

i. The right to obtain a "new lease" from the ground lessor in the event the ground lease is ever terminated, including being rejected in a bankruptcy proceeding.

C. Fee Mortgages

i. The leasehold estate and the leasehold mortgage should never become subordinate or inferior to a mortgage granted by the ground lessor on its fee simple estate.

ii. Subordination of the fee mortgage must include subordination to amendments and modifications of the ground lease, subleases and to any new lease given to the leasehold lender after termination or rejection of the original ground lease.

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She is the co-chair of the Cadwalader Asian Pacific American Attorney Resource Group (CAPAA) and was selected to be the firm's 2013 Fellow for the Leadership Council on Legal Diversity Fellows Program. She is also a member of the National Asian Pacific American Bar Association and the Asian American Bar Association of New York.

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Trends in the BSL and Middle Market CLO and ABL Markets

Neil Weidner

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Tax Reform Complicates Middle-Market CLOs

By **Jason Schwartz, Nathan Spanheimer and Cassidy Nolan**
(March 9, 2018, 12:57 PM EST)

The recently enacted Tax Cuts and Jobs Act is causing concerns for advisers of middle-market collateralized loan obligation issuers, or MM CLOs, that are engaged in a U.S. trade or business for U.S. tax purposes.[1] The TCJA includes Section 1446(f) of the Internal Revenue Code,[2] which potentially imposes a withholding requirement on any purchaser of noninvestment-grade notes issued by an MM CLO, or an entity-level tax on the MM CLO itself, unless the seller of the notes furnishes the purchaser with a “nonforeign affidavit” containing the seller’s U.S. taxpayer identification number and stating, under penalties of perjury, that the seller is not a foreign person.[3]


Jason Schwartz

Although investors in noninvestment grade notes issued by MM CLOs typically are restricted to U.S. persons, the deal documents for MM CLOs historically have not included a mechanism requiring a seller to provide a nonforeign affidavit to the purchaser, and purchasers might not be aware of the requirement to obtain a nonforeign affidavit or to withhold on sellers that fail to provide the affidavit. Moreover, because many MM CLO notes are traded through a depository institution, such as the Depository Trust Company, (1) a purchaser might not easily be able to withhold on the seller, and (2) an MM CLO might have difficulty determining whether withholding was properly effected.


Nathan Spanheimer

In 2017, MM CLO issuances in the United States reached a pre-crisis high of $14.7 billion.[4] Investors in MM CLOs do not expect an incremental tax drag on their investment returns, and MM CLOs generally must eliminate entity-level tax in order to receive a credit rating with respect to the senior and mezzanine notes that they issue. A failure by MM CLOs to require sellers of noninvestment-grade notes to deliver a nonforeign affidavit to both the purchaser and the MM CLO could adversely affect investors in both existing and future MM CLOs.

Overview of MM CLOs


Cassidy Nolan

MM CLOs are a subset of collateralized loan obligation issuers. CLOs are actively managed special-purpose vehicles that typically issue notes to institutional investors and use the proceeds primarily to acquire commercial loans.[5] Interest and, after a specified reinvestment period of four to five years, principal received by CLOs on their assets are used to pay interest and principal on the notes. CLOs hire collateral managers to manage their assets in exchange for management fees.

Most CLOs acquire broadly syndicated loans on the secondary market. These “broadly syndicated CLOs” usually are treated as foreign corporations for U.S. tax purposes and typically are organized in the Cayman Islands, which does not impose an income tax, or in Ireland, the Netherlands or Luxembourg, which permit interest deductions on the CLO notes to effectively eliminate any home jurisdiction income tax. U.S. collateral managers of broadly syndicated CLOs comply with “U.S. tax guidelines” that allow the CLO to satisfy a safe harbor that ensures that the CLO is not engaged in a U.S. trade or business and is not subject to U.S. net income tax.

By contrast, MM CLOs invest primarily in middle-market loans. Because the secondary market for middle-market loans is less developed than that for broadly syndicated loans, MM CLOs often act as original lenders on middle-market loans instead of buying loans on the secondary market.

The IRS asserts that regularly lending money through a U.S. agent (such as a U.S. collateral manager) constitutes a U.S. trade or business for U.S. tax purposes.[6] A foreign corporate CLO that is engaged in a U.S. trade or business potentially is subject to U.S. corporate-level tax. By contrast, entities that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business generally are not subject to entity-level tax so long as their equity is held exclusively by U.S. persons. Accordingly, to avoid U.S. entity-level tax, most MM CLOs are structured as partnerships for U.S. tax purposes, and require any notes they issue to be held by U.S. persons unless the notes receive an opinion of tax counsel that they will be treated as debt for U.S. tax purposes. Tax counsel typically gives such a “will be debt” opinion only with respect to an MM CLO’s investment-grade notes.

Section 1446(f) Generally

Section 1446(f) requires a purchaser of an equity interest in a partnership that is engaged in a U.S. trade or business for U.S. tax purposes (such as an MM CLO) to withhold 10 percent of a foreign seller’s amount realized. If the purchaser fails to withhold, then the partnership is required to withhold on future distributions to the purchaser, and could be subject to an entity-level tax liability if it fails to do so.

Section 1446(f) generally is intended to enforce Section 864(c)(8), which also was included in the TCJA. Under Section 864(c)(8), a foreign partner is subject to U.S. income tax on any gain that it recognizes on a sale or redemption of an equity interest in a partnership that is engaged in a U.S. trade or business to the extent that the foreign partner would have been subject to U.S. income tax if, on the date of the sale or redemption, the partnership had sold all of its assets at fair market value.[7] Any withholding under Section 1446(f) generally may be credited against the foreign partner’s ultimate U.S. tax liability.

Application of Section 1446(f) to MM CLOs

The primary withholding requirement under Section 1446(f) is intended to apply only to a purchaser of partnership equity from a foreign partner. As mentioned above, MM CLOs restrict the ownership of their notes to U.S. persons unless the notes receive an opinion of tax counsel that they will be debt for U.S. tax purposes. Accordingly, as a policy matter, Section 1446(f) should not impose a withholding requirement on purchasers of MM CLO notes, because the transfer restrictions contained in an MM CLO’s deal documents require each seller to be either (1) a U.S. person or (2) a debt holder.

Unfortunately, however, the only bright-line exception from withholding liability under the statutory language of Section 1446(f) is if the seller furnishes the purchaser with a nonforeign affidavit containing the seller's U.S. taxpayer identification number and stating, under penalties of perjury, that the seller is a U.S. person. As a result, a purchaser of noninvestment-grade notes (which, as noted above, do not receive an opinion that they are debt for U.S. tax purposes) risks incurring liability for failing to withhold on a seller if (1) the notes are treated as equity, (2) the purchaser relies solely on the MM CLO's transfer restrictions to assume that the seller is a U.S. person, and (3) the seller is, in fact, a non-U.S. person (in contravention of the MM CLO's transfer restrictions). Moreover, in this event, the MM CLO is required to withhold on future distributions to the purchaser to the extent that the purchaser failed to withhold on the seller and, if the MM CLO does not withhold, then it may be subject to entity-level tax liability for failure to do so (which would reduce amounts available for distribution to investors).[8]

When a seller directly sells a physical MM CLO note to a purchaser, the MM CLO can require the purchaser to ask the seller for a nonforeign affidavit to comply with Section 1446(f), and to withhold on any seller that fails to provide the affidavit. However, as mentioned above, many MM CLO notes are traded through a depository institution, such as the Depository Trust Company. What this means is that the depository institution is the registered holder of a "global" certificate that entitles it to payments on the MM CLO's notes, and brokers that have a relationship with the depository institution purchase interests in the global certificate on behalf of their clients.

It is unclear how withholding would be effected through a depository institution, which is unlikely to register a transfer of beneficial ownership of an MM CLO note unless it receives the note's full purchase price (without withholding). In addition, interposing a depository institution (as well as relationship brokers) between a purchaser and a seller potentially creates communication issues between the MM CLO, the purchaser and the seller, which could make it difficult for the MM CLO to determine whether a purchaser received a nonforeign affidavit or whether withholding was properly effected.

Documentary Solutions

One possible way for MM CLOs to address Section 1446(f) going forward would be to require each seller of a noninvestment-grade note to furnish the purchaser and the indenture trustee with a nonforeign affidavit as a condition to registering the sale. This would likely satisfy the bright-line withholding exemption in Section 1446(f), and therefore should absolve both the purchaser and the MM CLO from liability if the notes are treated as equity and the seller is not, in fact, a U.S. person. However, it remains to be seen whether any communication issues between sellers and purchasers will arise (in particular with respect to notes held in global form) in connection with this requirement.

It is unclear how Section 1446(f) will affect MM CLOs that closed before its enactment in the absence of an amendment to their deal documents to adopt the approach mentioned above, but there is a risk that the provision will adversely affect the liquidity of their global noninvestment-grade notes. Moreover, in the event that (1) an MM CLO's notes are treated as equity, (2) a purchaser does not withhold on a seller, and (3) the seller turns out to be a non-U.S. person, the IRS might assess a liability on the MM CLO for failing to withhold on the purchaser. This liability would be payable as an administrative expense and likely would be borne economically by the holders of the MM CLO's equity.

Closing Observations

The IRS has broad authority to issue regulations and other official guidance under Section 1446(f),[9] and has already exercised this authority to temporarily suspend the application of Section 1446(f) to purchasers of publicly traded partnership interests pending the issuance of regulations.[10]

From a U.S. tax perspective, a depository institution's role in effecting transfers of global notes is similar to a clearing institution's role in effecting transfers of publicly traded partnership interests. In both cases, the institution's involvement could create communication issues between a seller, purchaser and issuer, could prevent a purchaser from being able to withhold on the seller, and could prevent the issuer from knowing whether withholding was effected. Accordingly, advisers of MM CLOs might reasonably hope for a similar suspension.[11] In the meantime, however, they must be creative and thoughtful in mitigating the potential adverse effects of Section 1446(f) on the MM CLO market.

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[1] The concern discussed in this article applies only to MM CLOs (and any other CLOs) that are engaged in a U.S. trade or business for U.S. tax purposes.

[2] All references to section numbers herein are to the U.S. Internal Revenue Code of 1986, as amended.

[3] MM CLOs might issue interests in the form of notes, limited partnership interests or limited liability company interests. For convenience, this article refers to MM CLO interests as "notes."

[4] Fitch Ratings, Fitch: Strong CLO Appetite Keeps Issuance at Highs (Jan 25, 2018), available at https://www.fitchratings.com/site/pr/1035574.

[5] For a detailed discussion of the structure and taxation of CLOs, see Jason Schwartz and David S. Miller, Collateralized Loan Obligations, 6585 Tax Mgmt. Port. (BNA) (2018).

[6] See AM 2009-010.

[7] Section 864(c)(8) is intended to codify the IRS' conclusion in Revenue Ruling 91-32. In 2017, the Tax Court rejected this conclusion and held that a foreign partner was not subject to U.S. income tax on a redemption of an equity interest in a partnership that was engaged in a U.S. trade or business except to the extent that the gain was attributable to U.S. real property interests. See Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3(July 13, 2017). Section 864(c)(8) effectively overrides Grecian Magnesite Mining.

[8] Before tax reform, Section 1446(a) required MM CLOs to withhold on income and gain allocated to foreign partners. To eliminate this withholding requirement, the deal documents for most MM CLOs require purchasers of noninvestment-grade notes to provide the indenture trustee with an IRS Form W-9 certifying that the purchasers are U.S. persons. An MM CLO generally may rely on an IRS Form W-9 to eliminate Section 1446(a) withholding liability in the absence of actual knowledge or reason to know

that the form is inaccurate. See Treas. Reg. Section 1.1446-1(c)(2)(iii).

However, it is unclear whether Section 1446(f) allows an MM CLO to rely on an IRS Form W-9, even though there is no obvious policy reason to prohibit such reliance. See New York State Bar Association, Request for Immediate Guidance under Sections 864(c)(8) and 1446(f), Report No. 1387, at 8 (Feb. 2, 2018) (requesting guidance confirming that an IRS Form W-9 qualifies as a nonforeign affidavit). Thus, even if an MM CLO has an IRS Form W-9 on file with respect to a seller of noninvestment-grade notes, it is possible that the MM CLO will have withholding liability under Section 1446(f) if the purchaser does not receive a nonforeign-affidavit from the seller and does not withhold.

[9] See section 1446(f)(6) ("The Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of this subsection, including regulations providing for exceptions from the provisions of this subsection."); Section 1446(g) ("The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.").

[10] See Notice 2018-08 (acknowledging concerns that, "in the case of a disposition of a publicly traded partnership interest, applying new section 1446(f) without guidance presents significant practical problems").

[11] Although the suspension applies only to publicly traded partnership interests, the notice also requests comments on "whether a temporary suspension of new section 1446(f) for partnership interests that are not publicly traded partnership interests is needed." See also New York State Bar Association, Request for Immediate Guidance under Sections 864(c)(8) and 1446(f), Report No. 1387, at 4 (Feb. 2, 2018) ("[W]e recommend that either (i) Treasury and the Service issue immediate guidance that addresses the most pressing issues regarding the manner in which withholding under Section 1446(f) is to be conducted or (ii) if workable guidance cannot be issued in a very short period of time, the application of withholding for all partnership interests be delayed until regulations or other guidance is issued.").

Challenges in Commercial Real Estate Lending: Where Do We Go From Here?

Christopher Dickson

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Challenges in Commercial Real Estate Lending: Where Do We Go From Here?

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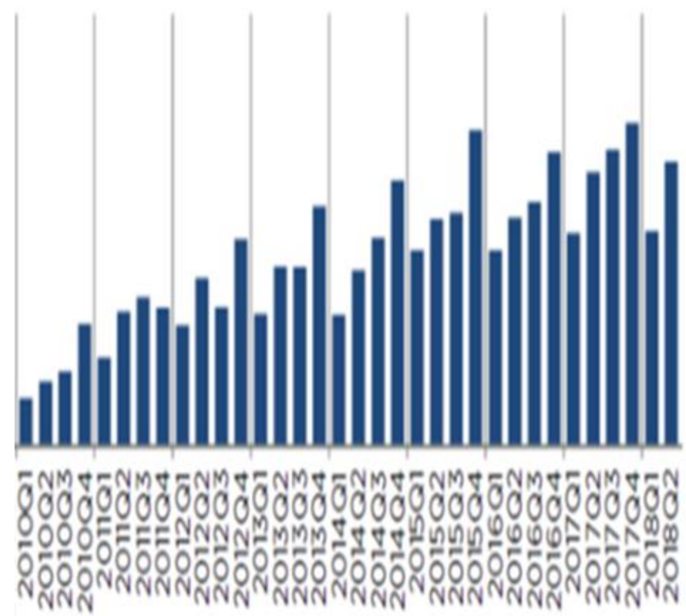
FINANCE FORUM 2018

THE CURRENT STATE OF THE MARKET

- 2018-Q2 commercial and multifamily loan originations were 4% higher than 2017-Q2 and 32% higher than 2018-Q1.
- 2018-Q2 year-over-year variations in dollar volume:
  - Hotel: +22%
  - Multifamily: +17%
  - Retail: +1%
  - Office: -4%
  - Industrial: -10%
  - Health Care: -16%
- 2018-Q2 vs. 2018-Q1 in dollar volume:
  - Hotel: +89%
  - Multifamily: +25%
  - Retail: +87%
  - Office: +36%
  - Industrial: +9%
  - Health Care: -9%

Commercial/Multifamily Mortgage Bankers Origination Index



DOLLAR VOLUME BY LENDER TYPE

- 2018-Q2 year-over-year:
  - CMBS: -8%
  - Government Sponsored Entities: +18%
  - Commercial Bank Portfolios: -1%
  - Life Insurance Companies: +6%
- 2018-Q2 vs. 2018-Q1:
  - CMBS: +79%
  - Government Sponsored Entities: +33%
  - Commercial Bank Portfolios: +22%
  - Life Insurance Companies: +21%
- Mortgage Bankers Association forecasts $549 billion in commercial and multifamily originations by year-end 2018
  - Down 3% from 2017
  - Project near-flat volume in 2019

Commercial/Multifamily Mortgage Bankers Originations Index

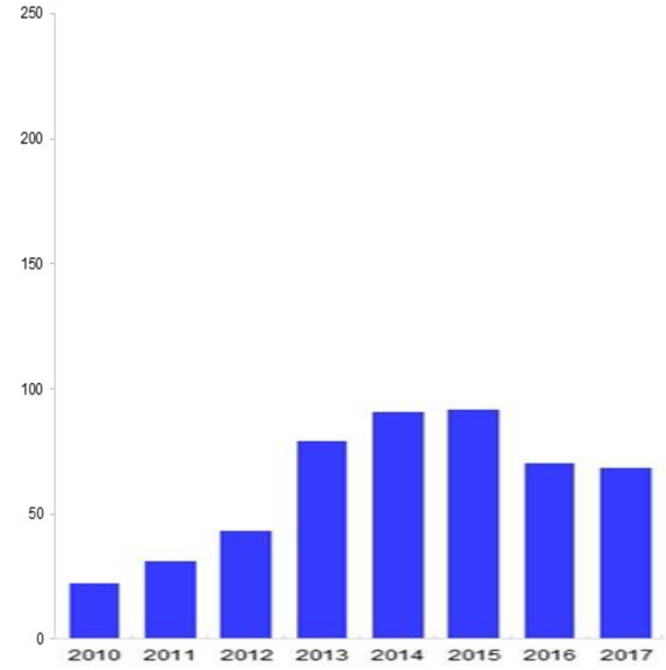
	Origination Volume Index (2001 Avg Qtr = 100)				Percent Change,		
	Q1	Q2	Q3	Q4	Year-over-year Q2	Q1-to-Q2	YTD-YTD
TOTAL							
2015	182	210	217	293	29%	16%	37%
2016	182	212	227	272	1%	17%	0%
2017	198	254	274	300	20%	28%	15%
2018	200	264			4%	32%	2%
CMBS/Conduits							
2015	106	96	117	121	-17%	-10%	22%
2016	86	57	112	118	-40%	-33%	-29%
2017	71	153	159	150	168%	117%	57%
2018	79	141			-8%	79%	-2%
Commercial Banks							
2015	263	381	416	625	64%	45%	29%
2016	379	507	380	521	33%	33%	38%
2017	420	400	459	496	-21%	-5%	-7%
2018	325	396			-1%	22%	-12%
Life Insurance Companies							
2015	314	345	391	456	14%	10%	29%
2016	309	396	379	428	15%	28%	7%
2017	309	386	370	410	-2%	25%	-1%
2018	337	408			6%	21%	7%
Fannie Mae/Freddie Mac							
2015	387	404	290	549	113%	4%	177%
2016	304	391	528	572	-3%	29%	-12%
2017	403	492	644	667	26%	22%	29%
2018	436	581			18%	33%	14%

	Origination Volume Index (2001 Avg Qtr = 100)				Percent Change,		
	Q1	Q2	Q3	Q4	Year-over-year Q2	Q1-to-Q2	YTD-YTD
Multifamily							
2015	260	317	293	431	58%	22%	63%
2016	265	313	369	428	-1%	18%	0%
2017	303	380	424	496	21%	25%	18%
2018	356	445			17%	25%	17%
Office							
2015	97	111	152	150	22%	14%	35%
2016	115	123	145	159	11%	7%	15%
2017	117	164	156	171	33%	39%	18%
2018	116	157			-4%	36%	-3%
Retail							
2015	125	227	289	332	17%	81%	12%
2016	180	206	224	270	-9%	14%	10%
2017	139	187	205	162	-9%	34%	-16%
2018	101	189			1%	87%	-11%
Industrial							
2015	610	247	245	614	32%	-60%	143%
2016	265	270	324	588	9%	2%	-38%
2017	372	517	389	486	91%	39%	66%
2018	424	464			-10%	9%	0%
Hotel							
2015	322	470	332	766	16%	46%	28%
2016	331	416	231	470	-11%	26%	-6%
2017	198	473	500	656	14%	139%	-10%
2018	306	576			22%	89%	31%
Health Care							
2015	102	91	96	115	-50%	-11%	-32%
2016	44	33	40	88	-64%	-25%	-60%
2017	54	36	78	56	7%	-34%	15%
2018	33	30			-16%	-9%	-30%

BREAKING THROUGH THE "WALL OF MATURITIES"

- More than $450 billion CMBS were issued in 2006 and 2007, with many backed by 10-year mortgages, which resulted in a "Wall of Maturities" in 2016 and 2017.
- 2017 marked the final summit of the "Wall of Maturities" due to many commercial and multifamily mortgages being 10-year loans with very few loans issued in 2008.
- $102.2 billion of the $1.8 trillion outstanding commercial and multifamily mortgages held by non-bank lenders and investors, representing only 6%, will mature in 2018.
- This represents a 42% decrease from the $175.9 billion in loans that matured in 2017.

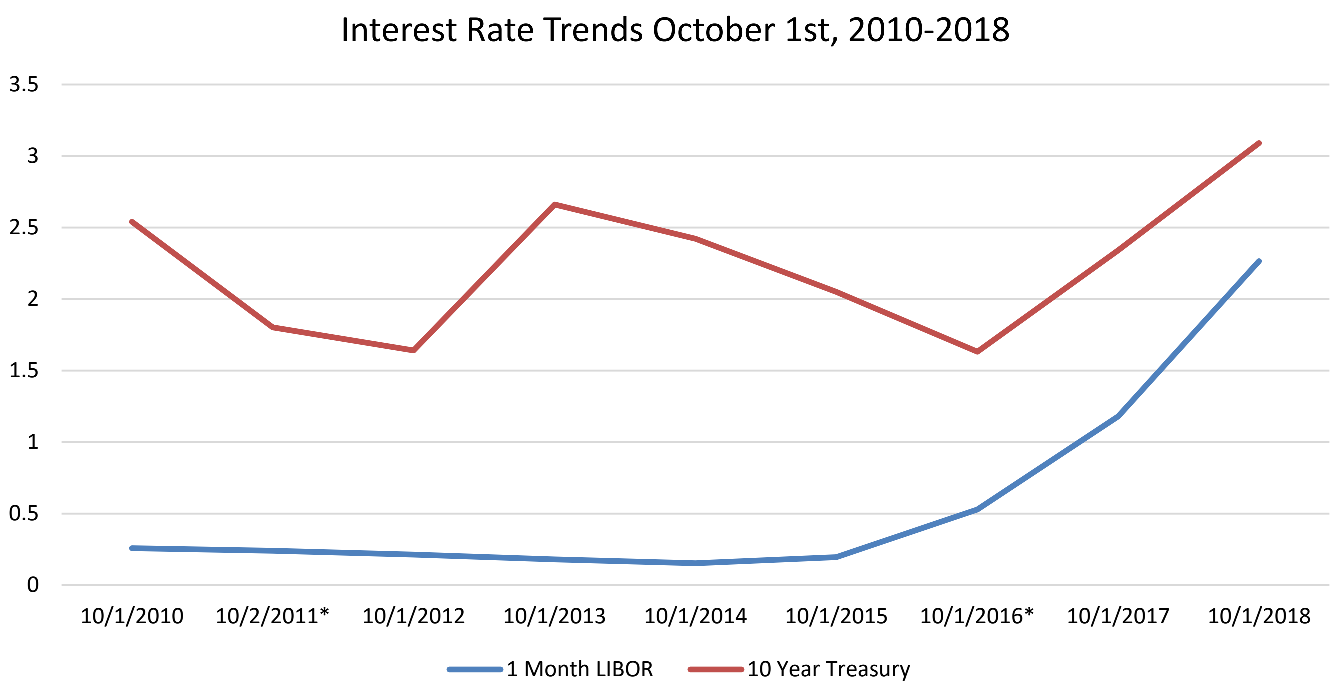
CMBS Issuance
(In Billions of USD)



TRENDS IN THE SYNDICATED LOAN MARKET

- An increase in the number of lenders pursuing loan participations has resulted in higher levels of competition.
- Theory: In order to compete and increase their market share, some lenders have begun taking down larger portions of the loans, or even the entire mortgage.
- This trend is leading to a reduction in the supply of syndication opportunities for other lenders.
- From a Borrower's perspective:
  - This gives Borrowers more autonomy to "club" deals themselves with a handful of lenders.
  - Borrowers can now obtain commitments from multiple banks, matching them up and effectively syndicating the loan themselves.
  - This avoids paying premiums to origination banks who later syndicate such loans.

INTEREST RATE TRENDS



Commercial Real Estate CLOs: A Market Resurgence

Jeffrey Rotblat

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Recent Trends In Structuring CRE-CLOs

By **Jason Schwartz, Gary Silverstein and Jeffrey Rotblat** (July 16, 2018, 1:58 PM EDT)

Jason Schwartz

Gary Silverstein

Jeffrey Rotblat

Commercial real estate collateralized loan obligations, or "CRE-CLOs," are growing in popularity as a way to securitize mortgage loans. Market participants have predicated as much as $14 billion of new CRE-CLO issuances in 2018,[1] compared to $7.7 billion in 2017.[2]

CRE-CLOs are special-purpose vehicles that issue notes primarily to institutional investors, invest the proceeds mainly in mortgage loans, and apply the interest and principal they receive on the mortgage loans to pay interest and principal on the notes that they issue. CRE-CLOs allow banks, real estate investment trusts (REITs), funds and other mortgage loan originators to finance their mortgage loan portfolios, thereby freeing up capital that they can then use to make or acquire additional mortgage loans. By issuing multiple classes of notes into the capital markets with different seniorities and payment characteristics backed by a pool of mortgage loans, CRE-CLOs appeal to investors that may not be willing or able to invest directly in mortgage loans.

In many ways, CRE-CLOs are a more flexible financing option than real estate mortgage investment conduits, or REMICs, the long-reigning darling of commercial mortgage-backed securitizations. Unlike REMICs, CRE-CLOs may hold mezzanine loans, "delayed drawdown" loans, "revolving" loans (and, in some cases, preferred equity), may borrow against a managed pool of assets, and may have more liberty to modify and foreclose on their assets. But structuring a CRE-CLO is not without challenges, and failing to properly structure a CRE-CLO could create adverse tax consequences for investors and could even subject the CRE-CLO to U.S. corporate tax.

To avoid U.S. entity-level tax, CRE-CLOs generally are structured as either (1) a qualified REIT subsidiary, or QRS, or (2) a foreign corporation that is not a QRS. This article summarizes each structure.[3]

QRS Structure

QRSs are a creature of the REIT regime. A REIT is a special type of domestic corporation that invests predominantly in real estate assets, including real estate mortgages, and generally can eliminate U.S. corporate tax by distributing all of its net income to its shareholders on a current basis. Because of their investment strategy, REITs are common sponsors of CRE-CLOs.

Under the REIT rules, a QRS is a wholly owned subsidiary of a REIT whose separate existence is disregarded for U.S. tax purposes. Thus, if a CRE-CLO is established as a QRS, then the CRE-CLO will not be subject to U.S. corporate tax.

Limitation on Issuing Tax Equity

To maintain its status as a QRS, a CRE-CLO must ensure that all of its "tax equity" is beneficially owned by a single REIT. In other words, all interests issued by the CRE-CLO that are not indebtedness for tax purposes must continue to be owned by the REIT at all times.

One important factor in determining whether an instrument is treated as debt or equity for U.S. tax purposes is the reasonable likelihood of timely payment of principal and scheduled interest on the instrument. A note's credit rating generally is viewed as indicative of its likelihood of repayment, and U.S. tax counsel typically do not opine that a class of notes will be treated as debt for U.S. tax purposes unless that class receives an investment grade credit rating. Accordingly, QRS CRE-CLOs may not issue below-investment-grade notes or equity to third-party investors. Instead, these interests must be retained by the REIT (or an entity disregarded into a REIT).

Mitigating the Excess Inclusion Rules

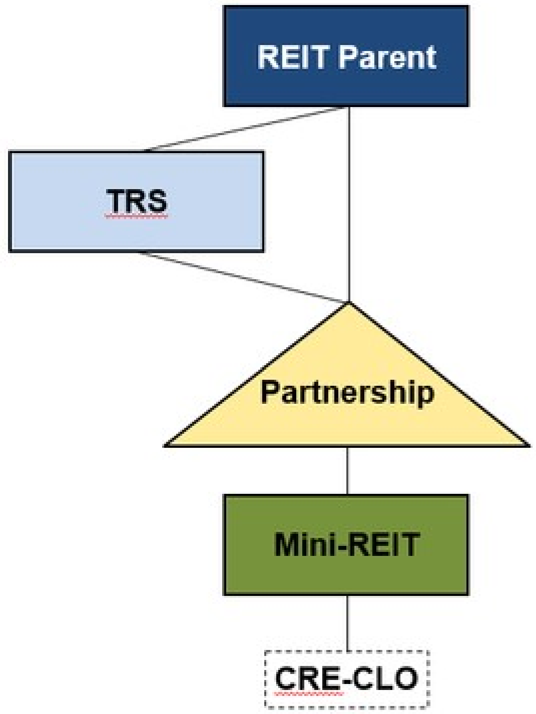
Very generally, a REMIC's most senior classes of economic interests provide for yields that are less than the weighted average interest rate of the pool of mortgage loans that the REMIC holds, while a REMIC's more junior classes of economic interests provide for yields that are greater than the weighted average interest rate of the pool of mortgage loans. Because the overall yield on these interests in early years is less than the overall yield on the pool of mortgage loans, a REMIC will have net taxable income in early years followed by net taxable losses in later years.

The REMIC rules generally ensure that someone pays tax on all or a portion of a REMIC's net taxable income, which is referred to as "excess inclusion" income. Consistent with this policy, because QRS CRE-CLOs (like REMICs) are not subject to entity-level tax, the tax code imposes material adverse tax consequences on a REIT and its shareholders (including otherwise tax-exempt shareholders) to the extent that dividends paid by the REIT are attributable to excess inclusion income of a QRS CRE-CLO.

IRS guidance requires REITs to determine the amount of excess inclusion income that is attributable to a QRS CRE-CLO using a "reasonable method." In the absence of further guidance, many tax advisers have concluded that a reasonable method includes treating the QRS CRE-CLO as a "synthetic REMIC," i.e., nominally treating a portion of the tax equity of the QRS as deductible, solely for purposes of computing excess inclusion income, much like a REMIC issues below-investment-grade regular interests, which are deductible (by statute) in computing a REMIC's overall net income. Under this approach, the excess inclusion income attributable to a QRS CRE-CLO more closely matches the excess inclusion income that would have been attributable to the QRS CRE-CLO had it made a valid REMIC election. However, it is not certain whether this approach would be respected if challenged.

REITs that wish to spare their shareholders the risk of any excess inclusion income will often create a "mini-REIT" to hold the QRS CRE-CLO's tax equity, and jointly own the mini-REIT with a taxable REIT subsidiary, or TRS. A TRS may be a wholly owned subsidiary of a REIT but, unlike a QRS, elects to be treated as a separate corporation from the REIT. A TRS that earns excess inclusion income is subject to U.S. corporate tax on the excess inclusion income; however, subsequent dividends by the TRS to the REIT are not treated as excess inclusion income. The TRS thus "blocks" the excess inclusion income from reaching the REIT and its shareholders.

This structure is illustrated below.



Because the mini-REIT owns all of the equity in the CRE-CLO, the CRE-CLO is eligible to be treated as a QRS. The mini-REIT realizes excess inclusion income from its ownership of the CRE-CLO, and dividends paid by the mini-REIT are tainted by any excess inclusion income. The partnership allocates the amount of any dividend income that consists of excess inclusion income to the TRS, and allocates all other dividend income directly to the REIT parent. Accordingly, only the excess inclusion income (and not the rest of the income attributable to the CRE-CLO's equity) is subject to corporate tax.

Non-QRS Structure

A CRE-CLO sponsor may choose not to use the QRS structure, for example, because REIT compliance is expensive, the sponsor is too closely held to qualify as a REIT, or the sponsor needs the flexibility to sell or freely finance the "tax equity." CRE-CLOs that do not qualify as QRSs and that issue two or more classes of notes are statutorily treated as corporations for U.S. tax purposes under the so-called "taxable mortgage pool" rules of the tax code. To avoid U.S. corporate tax, these CRE-CLOs typically are organized in the Cayman Islands, which does not impose corporate tax.

Cayman Islands corporations are subject to U.S. corporate tax only on income that is "effectively connected" with a "U.S. trade or business" for U.S. tax purposes. The IRS asserts that "making loans to the public" (instead of purchasing the loans on the secondary market), whether directly or through a U.S. agent, constitutes a U.S. trade or business. Because sponsors of CRE-CLOs often form the CRE-CLOs with the expectation of selling loans to them, non-QRS CRE-CLOs must follow special "tax guidelines" to ensure that the sponsor is not viewed as having engaged in loan origination as an agent of the CRE-CLO, causing the CRE-CLO to be engaged in a U.S. trade or business.

Although the precise contours of a CRE-CLO's tax guidelines often depend on the internal operations of the sponsor, U.S. tax counsel typically require some combination of the below features to ensure that the sponsor is not treated as originating loans as agent for the CRE-CLO:

- ***Seasoning Period With Arm's-Length Pricing.*** A significant waiting, or "seasoning," period between a loan's origination and a CRE-CLO's purchase of (or commitment to purchase) the loan helps ensure that the sponsor is the first person to bear economic risk with respect to the loan, which suggests that the sponsor is the true lender, and not an agent of the CRE-CLO. U.S. tax counsel often conclude that 90 days is a significant seasoning period on the basis that the loan market can change significantly during any 90-day period.

  In addition, to ensure that the seasoning period in fact creates market risk for the sponsor, the sponsor must sell any loans to the CRE-CLO at arm's-length pricing. Some U.S. tax advisers require the CRE-CLO to appoint an independent investment adviser to confirm that each loan is purchased at its fair market value.

- ***Autonomy of Origination Business.*** Another factor that strongly supports the conclusion that the sponsor is not originating loans as agent for the CRE-CLO is if the sponsor can establish that it has the capacity to originate loans whether or not the CRE-CLO in fact acquires the loans and the sponsor negotiates and originates loans without input from the CRE-CLO's investment management team. To ensure that no particular loan is substantially certain to be acquired by the CRE-CLO at the time that it is originated, some U.S. tax advisers also place a significant percentage limitation on the aggregate face amount of sponsor-originated loans the CRE-CLO can acquire.

- ***Incentive Compensation.*** Some CRE-CLOs provide for a material part of their investment management team's compensation to be based on the CRE-CLO's performance. This factor arguably further helps to establish separation between the origination and management personnel.

Conclusion

With careful tax planning, the CRE-CLO structures discussed above can be powerful tools for securitizing pools of assets that are inappropriate for acquisition by a REMIC, including assets that will be traded or will not consist solely of REMIC-eligible mortgages.

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[1] Cathy Cunningham, CREFC 2018: Say Hello to CLOs, Commercial Observer (Jan. 11, 2018), available at https://commercialobserver.com/2018/01/crefc-2018-say-hello-to-

clos.

[2] New Sponsors to Lift CLO Volume This Year, Commercial Mortgage Alert (Feb. 9, 2018), at 1.

[3] Special rules known as the taxable mortgage pool rules treat CRE-CLOs as corporations by statute, thus preventing CRE-CLOs from being structured as partnerships for tax purposes.

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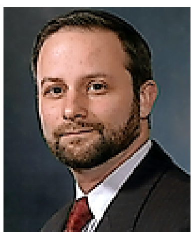
Real Estate

INSIGHT: The Taxation of Commercial Real Estate Collateralized Loan Obligations

BNA Snapshot

Jason Schwartz, Gary Silverstein, and Daniel Ng of Cadwalader, Wickersham & Taft discuss the tax considerations applicable to the growing market for commercial real estate collateralized loan obligations (CRE-CLOs). The authors analyze CRE-CLO structures that can be used for securitizing pools of assets that are inappropriate for acquisition by a real estate mortgage investment conduit (REMIC).


By Jason Schwartz, Gary Silverstein, and Daniel Ng

I. INTRODUCTION

Commercial real estate collateralized loan obligations, or "**CRE-CLOs**," are growing in popularity as a way to securitize mortgage loans. Market participants have predicated as much as $14 billion of new CRE-CLO issuances in 2018, compared to $7.7 billion in 2017.

In many ways, CRE-CLOs are a more flexible financing option than real estate mortgage investment conduits (**REMICs**), the traditional vehicles for commercial mortgage-backed securitizations: unlike REMICs, CRE-CLOs may hold mezzanine loans, "delayed drawdown" loans, and "revolving" loans (and, in some cases, preferred equity), may borrow against a managed pool of assets, and may have more liberty to modify and foreclose on their assets. But structuring a CRE-CLO is not without challenges, and failing to properly structure a CRE-CLO could create adverse tax consequences for investors and could even subject the CRE-CLO to U.S. corporate tax.

This article discusses the tax considerations applicable to CRE-CLOs. Part II briefly explains what a CRE-CLO is. Part III discusses the overarching tax considerations relevant to CRE-CLOs and provides a brief overview of the two most common CRE-CLO tax structures—the qualified REIT subsidiary (**QRS**) and the foreign corporation that is not a QRS. Parts IV and V contain a more detailed discussion of each of these tax structures. Part VI describes the material benefits of using a CRE-CLO instead of a REMIC to securitize mortgage loans.

II. WHAT IS A CRE-CLO?

CRE-CLOs are special purpose vehicles that issue notes primarily to institutional investors, invest the proceeds mainly in mortgage loans, and apply the interest and principal they receive on the mortgage loans to pay interest and principal on the notes that they issue. CRE-CLOs allow banks, real estate investment trusts (**REITs**), and other mortgage loan originators to sell their mortgage loan portfolios, freeing up capital that they can then use to make or acquire additional mortgage loans. By issuing multiple classes of notes with different seniorities and payment characteristics backed by a pool of mortgage loans, CRE-CLOs appeal to investors that may not be willing or able to invest directly in mortgage loans.

III. OVERARCHING TAX CONSIDERATIONS

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a. Taxable Mortgage Pool Rules

Under the taxable mortgage pool (**TMP**) rules of the Internal Revenue Code, a vehicle (other than a REMIC) that securitizes real estate mortgages generally is treated as a TMP and taxed as a separate corporation for U.S. tax purposes if it issues two or more classes of "debt" with different maturities and the payment characteristics of each debt class bear a relationship to payments on the underlying real estate mortgages.

The TMP rules are intended to subject any net income recognized by a domestic mortgage loan securitization vehicle—i.e., the positive difference between interest accruals on the vehicle's assets, on one hand, and interest accruals on the vehicle's obligations, on the other hand—to U.S. net income tax. (If the vehicle is a REMIC, no entity-level tax is imposed, but holders of a special class of "residual interests" must pay this tax, and the "excess inclusion" rules discussed below prevent all or a portion of the taxable income from being offset or otherwise eliminated.)

Because CRE-CLOs typically issue more than two classes of notes, they generally will be TMPs.

b. Avoiding Entity-Level Tax

As a condition to assigning a credit rating to any notes issued by a CRE-CLO, rating agencies typically insist that the CRE-CLO receive an opinion from U.S. tax counsel that the CRE-CLO "will not" be subject to an entity-level tax in the U.S.. Investors also expect this opinion, because a layer of corporate tax could dramatically reduce their investment returns.

Under Section 11(b), domestic entities that are treated as corporations for U.S. tax purposes generally are subject to a 21 percent net income tax. In addition, under Section 882, foreign entities that are treated as corporations for U.S. tax purposes are subject to U.S. federal income tax on any income that is "effectively connected" with the conduct of a "trade or business" within the U.S..

Accordingly, to avoid U.S. entity-level tax, CRE-CLOs generally are structured as one of the following:

- **Qualified REIT Subsidiary (a "QRS CRE-CLO")** . REITs are a special type of domestic corporation that invest predominantly in real estate assets, including real estate mortgages, and generally can eliminate U.S. corporate tax by distributing all of their net income to their shareholders on a current basis. Because of their investment strategy, REITs are common sponsors of CRE-CLOs.
    - Under the REIT rules, if a REIT owns all of the equity interests in another corporation (which is referred to as a qualified REIT subsidiary, or "**QRS**"), then (absent an election otherwise) the QRS's assets, liabilities, and items of income, loss, and deduction are treated as the assets, liabilities, and items of income, loss, and deduction of the REIT itself. Thus, if a CRE-CLO is established as a QRS, then the CRE-CLO will not be subject to U.S. corporate tax, even if it is also treated as a TMP (i.e., even though it is a "**QRS-TMP**"). Instead, for U.S. tax purposes, the REIT is treated as the direct owner of the QRS's investment portfolio and is treated as pledging the portfolio as collateral for the notes that the QRS issues.
    - To maintain its status as a QRS, a CRE-CLO must ensure that all of its "tax-equity" is beneficially owned by a single REIT.
- **Foreign corporation that is not a QRS and is not engaged in a U.S. trade or business (non-QRS CRE-CLO)** . CRE-CLOs that do not qualify as QRSs typically are organized in the Cayman Islands, which does not impose corporate income tax, and comply with "tax guidelines" to ensure that they are not engaged in a U.S. trade or business and thus are not subject to U.S. net income tax under Section 882. Although tax guidelines generally limit a CRE-CLO's origination and workout activities, a non-QRS CRE-CLO can issue tax-equity to outside investors (which a QRS CRE-CLO cannot do).

IV. QRS CRE-CLOS: SPECIAL TAX CONSIDERATIONS

a. Limitation on Issuing Tax-Equity

A QRS is a corporation whose "tax-equity" is 100 percent owned by a REIT. CRE-CLOs issue multiple classes of notes into the capital markets with different seniorities. Accordingly, in order to opine that a CRE-CLO "will not" be subject to an entity-level tax in the U.S. on the basis that it is a QRS, U.S. tax counsel require a REIT to retain any classes of notes issued by the CRE-CLO that could be treated as equity for U.S. tax purposes—i.e., that do not receive an opinion that they "will" be treated as debt for U.S. tax purposes. This retention requirement is one of the most limiting downsides of using a QRS CRE-CLO

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instead of a non-QRS CRE-CLO. (If the sponsor is not already a REIT, then creating and maintaining a REIT also may be a significant downside of using a QRS CRE-CLO.)

Whether an instrument is treated as debt or equity for U.S. tax purposes depends on the facts and circumstances on the instrument's issue date, and no one factor is determinative. One important factor is the reasonable likelihood of timely payment of principal and scheduled interest on the instrument.

A note's credit rating is generally viewed as indicative of its likelihood of repayment, and U.S. tax counsel typically do not opine that a class of notes will be treated as debt for U.S. tax purposes unless that class receives an investment grade credit rating—e.g., Baa3 or higher from Moody's, or BBB- or higher from Fitch. Accordingly, QRS CRE-CLOs generally may not issue below-investment-grade notes or equity to third-party investors. Instead, these interests must be retained by the REIT (or any entity disregarded into a REIT).

b. Excess Inclusion Income

i. Overview

REITs are treated as domestic corporations for U.S. tax purposes. As a result, U.S. tax-exempt investors generally are not subject to U.S. “unrelated business income tax” on dividends that they receive from a REIT. Non-U.S. investors generally are subject to 30 percent U.S. withholding tax on dividends that they receive from a REIT, but the amount of this withholding tax may be reduced by an applicable income tax treaty. In addition, as mentioned above, REITs generally can eliminate U.S. corporate tax by distributing all of their net income to their shareholders on a current basis.

However, when a REIT holds a REMIC residual interest, the REIT must allocate a certain amount of taxable income attributable to the REMIC residual interest, referred to as “excess inclusion income,” among the REIT's shareholders in proportion to the dividends that the REIT pays. This excess inclusion income is subject to adverse treatment (as discussed below).

Similarly, Section 7701(i)(3) provides that, if a REIT holds a QRS-TMP, such as a QRS CRE-CLO, then the REIT's shareholders are subject to tax consequences “similar to” those that would apply if the REIT held a REMIC residual interest. Although the Internal Revenue Service has not issued regulations under Section 7701(i)(3), it has concluded that Section 7701(i)(3) establishes several basic principles, which apply even in the absence of regulations:

• First, the REIT must determine the amount of the QRS-TMP's excess inclusion income under “a reasonable method.”

• Second, non-U.S. persons may not claim the benefits of an income tax treaty to reduce withholding on REIT dividends of excess inclusion income, and thus are always subject to 30 percent U.S. withholding tax on the excess inclusion income.

• Third, REIT dividends of excess inclusion income to tax-exempt shareholders are treated as unrelated business taxable income (UBTI). As a result, tax-exempt entities are subject to corporate tax on this portion of their REIT dividends.

• Fourth, taxable U.S. investors may not use net operating losses to reduce taxable income that is attributable to REIT dividends of excess inclusion income.

• Finally, the REIT must pay tax on any excess inclusion income that is allocable to governmental entities and other “disqualified organizations.”

ii. Excess Inclusion Income of a QRS-TMP

IRS Notice 2006-97 requires REITs to determine excess inclusion income attributable to a QRS-TMP using “a reasonable method.” However, the tax code defines excess inclusion income only under the rules governing REMICs. REMICs issue multiple classes of regular interests, which are statutorily treated as debt for U.S. tax purposes and are paid down in sequence with principal collections on the REMIC's pool of mortgage loans, and one class of residual interests, which is the REMIC's “tax-equity” and is subordinated to the regular interests. The excess inclusion regime subjects a REMIC's net taxable income to U.S. income tax in the hands of the holder of the REMIC's residual interest.

Because REMIC regular interests are statutorily treated as debt for U.S. tax purposes, regardless of how little equity supports them, virtually all REMICs are structured so that their residual interests are non-economic, meaning that they do not receive any cash. The REMIC's most senior classes of regular interests provide for yields that are less than the weighted average

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interest rate of the pool of mortgage loans that the REMIC holds, while the REMIC's most junior classes provide for yields that are greater than the weighted average interest rate of the pool mortgage loans. Because the overall yield on the classes of regular interests issued by the REMIC in early years is less than the overall yield on the pool of mortgage loans its holds, a REMIC will have net taxable income in early years, and then (as the senior classes are paid down) will have net taxable losses in later years. Even though the REMIC's net taxable losses offset its net taxable income over time, the taxable losses are incurred in later years. Thus, in present value terms, a non-economic REMIC residual interest represents an economic liability, not an asset.

QRS-TMPs must have a significant amount of equity in order to be able to issue notes senior to the equity that receive an opinion of U.S. tax counsel that they “will” be treated as debt for U.S. tax purposes. As a result, QRS-TMP equity—unlike REMIC residual interests—always is entitled to cash distributions, and thus has positive value. If excess inclusion income attributable to a QRS-TMP were determined by treating the entire equity interest in the QRS-TMP as if it were a REMIC residual interest, the excess inclusion income would be significantly greater than if the QRS-TMP had made a valid REMIC election and had issued additional junior regular interests and a non-economic residual interest.

The legislative history to Section 7701(i)(3) suggests that Congress might, indeed, have expected the excess inclusion income attributable to a QRS-TMP to be determined by treating the QRS-TMP's entire equity interest as if it were a REMIC residual interest. On the other hand, Congress does not appear to have contemplated the widespread use of non-economic REMIC residual interests, and there is no readily apparent policy justification to require holders of QRS-TMP equity to report significantly greater excess inclusion income than holders of REMIC residual interests, particularly in light of the directive in Section 7701(i)(3) for the IRS to promulgate regulations taxing shareholders in a REIT that holds a QRS-TMP in a manner “similar to” shareholders in a REIT that holds a REMIC residual interest.

Accordingly, a “reasonable method” of determining excess inclusion income attributable to a QRS CRE-CLO may include treating the QRS CRE-CLO as a “synthetic REMIC,” i.e., nominally treating a portion of the payments on the QRS's tax-equity as deductible solely for purposes of computing excess inclusion income, much like interest payments on a REMIC's below-investment-grade regular interests are deductible in computing the REMIC's overall net income Under this approach, the QRS CRE-CLO's equity is bifurcated into (1) one or more “synthetic” regular interests that are entitled to all cash-flows associated with the equity and has an issue price equal to its fair market value, and (2) a synthetic non-economic residual interest. The net taxable income attributable to the synthetic non-economic residual interest is calculated by permitting the synthetic REMIC to deduct (x) any interest that it actually pays or accrues on its notes, (y) any interest payments that it is deemed to pay or accrue on the synthetic regular interests, and (z) any other expenses of the QRS CRE-CLO to the extent that they would be deductible to a REMIC in computing the REMIC's taxable income. The result of this approach is that excess inclusion income attributable to the QRS CRE-CLO generally matches the excess inclusion income that would have been attributable to the QRS CRE-CLO's non-economic residual interest had the QRS CRE-CLO made a valid REMIC election. However, it is not certain whether this approach would be respected if challenged.

iii. Blocking Excess Inclusion Income

As mentioned above, a REIT and its shareholders may be subject to adverse tax consequences as a result of the REIT's realization of excess inclusion income. REITs that wish to spare their shareholders from having any excess inclusion income will often create a “mini-REIT” to hold the QRS CRE-CLO tax-equity, and jointly own the mini-REIT with a wholly owned taxable REIT subsidiary (**TRS**).

Like a QRS, a TRS is a subsidiary of a REIT. Unlike a QRS, a TRS is treated as a separate corporation from the REIT. A REIT and its subsidiary must jointly elect for the subsidiary to be a TRS.

A TRS that earns excess inclusion income is subject to U.S. corporate tax (currently imposed at a 21 percent rate) on the excess inclusion income. Because the TRS earns and pays tax on the excess inclusion income, subsequent dividends by the TRS to the REIT should not be treated as excess inclusion income. The TRS thus “blocks” the excess inclusion income from reaching the REIT and its shareholders.

Because a CRE-CLO is treated as a QRS only if it is wholly owned by a REIT, bringing a TRS into the picture requires some additional tax structuring. Specifically, the REIT (which we refer to as the “**REIT parent**”) invests in (1) a TRS and (2) a partnership. The TRS also invests in the partnership. The partnership's sole asset is the equity in a new entity that, itself, makes a valid election to be treated as a REIT (the “**mini-REIT**”). The mini-REIT owns the equity in the CRE-CLO.

This structure is illustrated below.

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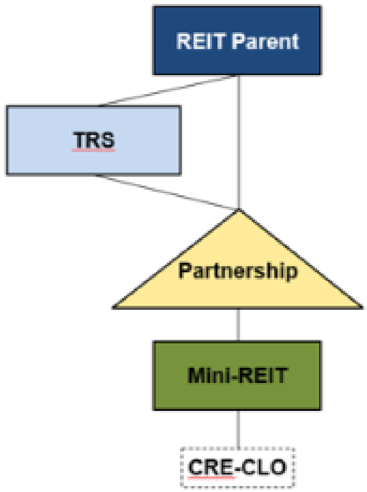

Because the mini-REIT owns all of the equity in the CRE-CLO, the CRE-CLO is eligible to be treated as a QRS. The mini-REIT realizes excess inclusion income from its ownership of the CRE-CLO, and dividends paid by the mini-REIT are tainted by any excess inclusion income. The partnership allocates the amount of any dividend income that consists of excess inclusion income to the TRS, and allocates all other dividend income directly to the REIT parent. Accordingly, only the excess inclusion income (and not the rest of the income attributable to the CRE-CLO's equity) is subject to corporate tax.

V. NON-QRSCRE-CLOS: SPECIAL TAX CONSIDERATIONS

a. Avoiding a U.S. Trade or Business

i. Overview

As mentioned above, non-U.S. entities that are treated as corporations for U.S. tax purposes are subject to U.S. federal income tax on any income that is “effectively connected” with the conduct of a “trade or business” within the U.S.. The IRS asserts that “making loans to the public” within the U.S. (instead of purchasing the loans on the secondary market), whether directly or through a U.S. agent, constitutes a U.S. trade or business. Accordingly, tax guidelines for non-QRS CRE-CLOs typically have three overarching principles:

- The CRE-CLO may not negotiate the terms of a loan.
- The CRE-CLO may not be an original lender.
- The CRE-CLO may not be the first person to bear economic risk with respect to a loan.

These principles are predicated on the traditional view of a “lender” as the party that negotiates the loan, funds the loan, bears first risk with respect to the loan, and holds itself out as the lender.

A significant body of literature addresses the particulars of tax guidelines followed by “broadly syndicated” CLOs, which purchase small portions of broadly syndicated commercial loans. As a general matter, broadly syndicated loans are more liquid than mortgage loans, are not secured by real property, are originated by banks that are not related to the CLO, and are traded through electronic brokerage platforms. This article focuses on two issues that do not frequently arise for broadly syndicated CLOs, but commonly arise for CRE-CLOs because they invest in whole mortgage loans that their sponsor (or an affiliate of the sponsor) originated.

ii. Sponsor-Originated Loans

REITs, loan funds, banks, and other sponsors commonly form CRE-CLOs to purchase mortgage loans that the sponsors originated, and delegate their own employees (or the employees of an affiliate) to make the CRE-CLOs’ investment decisions. Because the sponsor expects to sell its loans to the CRE-CLO, and the CRE-CLO expects to buy loans from the sponsor, U.S. tax counsel must consider whether the sponsor could be viewed as having engaged in loan origination as an agent of the CRE-CLO, causing the CRE-CLO to be engaged in a U.S. trade or business. This analysis depends, in part, on whether the

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CRE-CLO holds a “static” or “managed” pool of mortgages.

1. Static CRE-CLOs

Some CRE-CLOs hold a “static” (non-traded) pool of mortgages and apply all principal collections on the mortgages toward paying down the notes that they issue (instead of using those principal collections to acquire new mortgages). An argument exists that these static CRE-CLOs are not engaged in a trade or business, but rather are “investors” for U.S. tax purposes, even if the sponsor's loan origination activities are imputed to the CRE-CLOs under an agency theory.

The distinction between a person that conducts mere investment activities (i.e., an “investor”) and a person that is engaged in a business is that the former's activities are “more isolated and passive,” whereas the latter's are “frequent, continuous, and regular.” The number of purchases and amount and magnitude of activities associated with acquiring investments are usually less relevant under the existing trade or business authorities than the number of sales, and courts and the IRS have held that active asset management activities (which arguably would include loan negotiation) do not cause an investor to become a engaged in a trade or business. Under this view, even a CRE-CLO that directly originates loans should not be engaged in a trade or business so long as it holds the loans to maturity instead of selling them.

On the other hand, lending is an activity conducted by banks, financing companies, and other U.S. businesses, and the IRS and courts have found taxpayers to be engaged in a trade or business for purposes of Section 166 (relating to bad debt deductions) as a result of regularly and continuously making loans, even if the taxpayers retain and do not sell the loans. Moreover, some authorities have treated lending as a “service,” although courts generally have held that the activity of making loans for investment and not for purposes of resale to a customer or otherwise to earn a spread is not a service.

Because there is no clear authority under Section 882 that making loans for investment does not constitute a trade or business, most static CRE-CLOs do not purchase loans from their sponsor if, at the time the sponsor originated the loans, the sponsor was committed to transfer the loans to the CRE-CLO. So long as the sponsor originates a loan without any preexisting commitment to transfer the loan to a CRE-CLO, the sponsor arguably cannot have originated the loan as an agent for the CRE-CLO, because it negotiated the terms of the loan, was the original lender, and was the first person to bear economic risk with respect to the loan. To bolster the argument that the loans were not originated with the expectation of transferring them to the CRE-CLO, some U.S. tax counsel prohibit the CRE-CLO from acquiring any loans that were originated earlier than the later of (1) some period of time (e.g., 90 days) before the CRE-CLO was formed, and (2) the date that the sponsor signed an engagement letter with its legal counsel to form the CRE-CLO.

2. Managed CRE-CLOs

The U.S. trade or business risk is more acute when the CRE-CLO is permitted to apply principal collections or sale proceeds to acquire mortgage loans on an ongoing basis. U.S. tax counsel often require some combination of the below features to ensure that the sponsor is not treated as originating loans as agent for the CRE-CLO after the CRE-CLO is formed.

• Seasoning period with arm's-length pricing. A significant waiting, or “seasoning,” period between a loan's origination and a CRE-CLO's purchase of (or commitment to purchase) the loan helps ensure that the sponsor was the first person to bear economic risk with respect to the loan, which suggests that the sponsor is the true lender, and not an agent of the CRE-CLO. U.S. tax advisors often conclude that 90 days is a significant seasoning period on the basis that the loan market can change significantly during any 90-day period.

In addition, to ensure that the seasoning period in fact creates market risk for the sponsor, the sponsor must sell any loans to the CRE-CLO at arm's-length pricing. Some U.S. tax advisors require the CRE-CLO to appoint an independent investment advisor to confirm that each loan is purchased at its fair market value.

• Autonomy of origination business. Another factor that strongly supports the conclusion that the sponsor is not originating loans as agent for the CRE-CLO is if the sponsor can establish that it has the capacity to originate loans whether or not the CRE-CLO in fact acquires the loans and the sponsor negotiates and originates loans without input from the CRE-CLO's investment management team. To ensure that no particular loan is substantially certain to be acquired by the CRE-CLO at the time that it is originated, some U.S. tax advisors also place a significant percentage limitation on the aggregate face amount of sponsor-originated loans that the CRE-CLO can acquire.

• Incentive compensation. Some CRE-CLOs provide for a material part of their investment management team's compensation to be based on the CRE-CLO's performance. This factor arguably further helps to establish separation

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between the origination and management personnel.

3. Wholly Owned CRE-CLOs

One additional way that a CRE-CLO might establish that it is not engaged in a U.S. trade or business is if the sponsor owns all of the CRE-CLO's equity. Treasury regulations Section 1.864-4(c)(5)(i) provides that financing subsidiaries generally are not treated as engaged in the active conduct of a banking, financing, or similar business in the U.S.. However, a sponsor may not want to be required to retain all of the tax-equity of a non-QRS CRE-CLO.

iii. Foreclosures

Under Section 897, a non-U.S. corporation's gain or loss from the sale or other disposition of a "United States real property interest" is subject to U.S. tax "as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business." A U.S. real property interest includes, among other things, real property located in the U.S. or the U.S. Virgin Islands.

Because substantially all of a CRE-CLO's assets consist of mortgage loans, there is a real risk that, at some point, a mortgage loan will default and the CRE-CLO will have the right to foreclose on the underlying real property. If the CRE-CLO is treated as a non-U.S. corporation for U.S. tax purposes and forecloses on U.S. real property, then it will be subject to U.S. federal income tax on any gain that it recognizes on a subsequent sale of that property, and will be required to file a U.S. federal income tax return.

The operative documents of many CRE-CLOs require the CRE-CLOs to isolate this tax and the U.S. federal income tax return filing obligation, in a U.S. "blocker" subsidiary. A blocker subsidiary should be respected as an entity separate from the CRE-CLO, and should not be treated as the CRE-CLO's agent, even though the CRE-CLO owns all of the equity interests of the blocker subsidiary. Thus, the blocker subsidiary, and not the CRE-CLO, is subject to U.S. corporate tax, and has to file U.S. federal income tax returns.

So long as a U.S. blocker subsidiary retains all of its earnings, it will not be required to withhold on dividends that it pays to the CRE-CLO. After the U.S. blocker subsidiary sells its assets, it can liquidate without having to withhold.

b. Avoiding U.S. Withholding Tax

Under Section 882, interest on indebtedness paid by a U.S. person to a non-U.S. corporation is subject to 30 percent U.S. withholding tax unless the interest qualifies as "portfolio interest." U.S.-source interest received by a foreign CRE-CLO on a mortgage loan generally will qualify as portfolio interest if:

- the mortgage loan is in registered form; and
- the amount of the interest is not determined by reference to the obligor's income, profits, receipts, sales, or other cash flows, changes in the value of the obligor's assets, or distributions on the obligor's equity.

A mortgage loan is in registered form if the right to receive payments of principal and stated interest on the loan may be transferred only through a book-entry system maintained by the obligor or its agent.

Mortgage loans sometimes contain an explicit requirement that the servicer, acting as an agent of the borrower, maintain a record of each lender and its assignees. This requirement ensures that the mortgage loans are in registered form.

If a mortgage loan does not contain this requirement, then a non-U.S. CRE-CLO may nevertheless eliminate the 30 percent U.S. withholding tax on interest payments made under the loan if it holds the loan through a domestic grantor trust. Under regulations Section 1.871-14(d)(1), interest received by a beneficiary from a grantor trust is treated as portfolio interest so long as the trust certificate held by the beneficiary is in registered form, even if the underlying obligations are not themselves in registered form. Accordingly, many CRE-CLOs hold their mortgage loans in a domestic grantor trust.

Very generally, a trust to which a person transfers property for the purpose of protecting and conserving the property for the transferor's benefit is treated as a grantor trust only if the trust has no "power to vary" the transferor's investment. A CRE-CLO's ability to trade the assets that it holds through a grantor trust might be construed as a power of the trust to vary the CRE-CLO's investment. However, because any transfer of assets into or out of the grantor trust may be effected only at the CRE-CLO's direction, the transfer should be treated in the same manner as (1) a liquidating distribution by the trust to the

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CRE-CLO, followed immediately by (2) the formation by the CRE-CLO of a new grantor trust. Thus, the CRE-CLO's ability to hold a managed pool of assets through a grantor trust should not cause the CRE-CLO to fail to qualify for the portfolio interest exemption.

c. Concerns for REIT Sponsors

REITs typically do not form non-QRS CRE-CLOs.

First, REITs generally are prohibited from owning securities representing more than 10 percent of the total voting power or value of any one issuer, unless (i) the REIT owns 100 percent of the equity in that issuer and the issuer is a QRS, or (ii) the issuer is a TRS. Accordingly, owning 10 percent or more, but less than 100 percent, of the equity interests in a CRE-CLO could jeopardize a REIT's tax classification. If a REIT intends to own 100 percent of a CRE-CLO, then the REIT can form a QRS CRE-CLO.

Second, REITs are subject to a 100 percent “prohibited transactions” tax on any gain from a sale of property held for sale to customers in the ordinary course of a trade or business. There is a real risk that a REIT's ongoing sale of mortgage loans to one or more non-QRS CRE-CLOs would be treated as prohibited transactions. (The same concern exists if a REIT sells mortgages to one or more REMICs). By contrast, a REIT's transfer of mortgage loans to a QRS CRE-CLO is disregarded for U.S. tax purposes.

d. Converting a QRS CRE-CLO into a Non-QRS CRE-CLO

A QRS is not required to be a domestic entity in form. Instead, a Cayman Islands entity may be used. The Cayman Islands entity would be disregarded for U.S. tax purposes so long as it is a QRS.

If a REIT organizes a QRS CRE-CLO in the Cayman Islands, then the REIT might be able to sell the CRE-CLO's equity after a waiting period. Upon the sale, the CRE-CLO would become a non-QRS CRE-CLO. Because it is organized in the Cayman Islands, the CRE-CLO would not be subject to U.S. corporate tax unless it is engaged in a U.S. trade or business.

The waiting period must be sufficiently long for U.S. tax counsel to be able to conclude that the sale does not cause the REIT to be treated as a dealer and subject to the prohibited transactions tax described in Part V.c. In addition, U.S. tax counsel must be able to conclude that the non-QRS CRE-CLO will not be engaged in a U.S. trade or business (including, possibly, as a result of any loan originations that it conducted when it was still a QRS CRE-CLO) and that interest payments that the non-QRS CRE-CLO receives are not subject to withholding tax (i.e., the non-QRS CRE-CLO might need to contribute its assets to one or more domestic grantor trusts to avail itself of the portfolio interest exemption, as discussed in Part V.b.).

VI. BENEFITS OF USING A CRE-CLO INSTEAD OF A REMIC

a. Overview

Both REMICs and CRE-CLOs issue multiple classes of interests that are backed by a pool of mortgage loans. However, CRE-CLOs are more flexible than REMICs in several ways. This section briefly summarizes the most material differences between REMICs and CRE-CLOs.

b. Static Pool

REMICs are subject to a 100 percent tax on “prohibited transactions,” which include a disposition of a mortgage loan other than in very specific situations. As a result, REMICs do not trade their assets. By contrast, as discussed above, CRE-CLOs are permitted to have either “static” or “managed” pools of assets. Moreover, REMICs generally may not acquire new assets more than three months after their startup day, and are limited in their ability to invest in delayed drawdown loans or revolving loans, each of which require a holder to make advances on a periodic basis that are treated as new loans for U.S. tax purposes. By contrast, CRE-CLOs generally may invest in delayed drawdown loans or revolving loans.

c. Limitations on Collateral

REMICs are required to invest almost exclusively in mortgage loans. By contrast, CRE-CLOs may invest in any assets, subject only to the following limitations:

- In the case of a QRS CRE-CLO, the asset must be an asset that the REIT is permitted to hold; and

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- In the case of a non-QRS CRE-CLO, ownership of the asset must not violate the CRE-CLO's tax guidelines (i.e., the non-QRS CRE-CLO must avoid being engaged in a U.S. trade or business).

Mezzanine loans and preferred equity generally are “good” REIT assets and do not violate tax guidelines, yet likely are not “qualified mortgages” under the REMIC rules. Accordingly, in addition to mortgage loans, CRE-CLOs generally may acquire mezzanine loans and QRS CRE-CLOs generally may also acquire preferred equity, while REMICs generally may not.

d. Limitations on Modifications and Foreclosures

With very limited exceptions, REMICs may not acquire new assets more than three months after their start-up day. For U.S. tax purposes, a “significant modification” of a mortgage loan is treated as an exchange of the loan for a new loan. Accordingly, REMICs must be careful to ensure that none of the loans that comprise their assets is significantly modified unless the modification falls within one of several narrow safe harbors described in Revenue Procedure 2010-30. Moreover, even if a loan modification is not significant, the modification could still cause the REMIC to lose its REMIC status if it causes the mortgage to no longer be “principally secured” by an interest in real property. Finally, if a REMIC forecloses on a mortgage loan, the REMIC generally may not hold the foreclosure property for more than a three-year period (with a possible extension of up to three years).

By contrast, non-QRS CRE-CLOs generally are not subject to limitations on their ability to modify loans, other than any limitations that may be imposed by tax guidelines. In addition, as discussed in Part V.a.iii, CRE-CLOs (unlike REMICs) may acquire foreclosure property through a U.S. blocker corporation, and are not subject to any limitation on the amount of time during which they can hold the U.S. blocker corporation or the foreclosure property.

VII. Conclusion

With careful tax planning, the two CRE-CLO structures discussed above can be powerful tools for securitizing pools of assets that are inappropriate for acquisition by a REMIC, for example, because the assets will be traded or will not consist solely of REMIC-eligible mortgages.

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Private Equity Secondaries Market: Evolving Deal Structures and the Use of Leverage

Brian Foster

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Private Equity Primary and Secondary Markets: Evolving Deal Structures and the Use of Leverage

October 9, 2018

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FINANCE FORUM 2018

Financing Limited Partners

- Subscription Lines
- Deferred Payment Arrangements
- NAV Loans
- Asset Based Loans

General Partner Led Transactions

- GP/Minority Stake Deals
- Preferred Equity
- Management Fee Credit Lines
- Hybrid Collateral Credit Lines

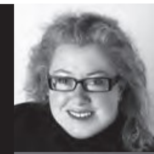
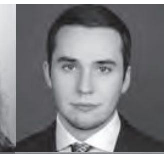
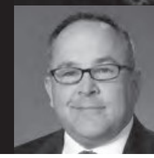
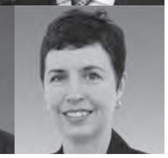
Debt Financing Structures

- Collateralized Fund Obligations
- Preferred Shares
- Dividend Recap Transactions

CMBS – A Roundtable

David Burkholder

Jennifer Jones | Vice President, CMBS Senior Loan Analyst | Morningstar
Michael Fedorochko | Associate, CMBS Credit Analyst | Morningstar
David Putro | Senior Vice President, CMBS | Morningstar
Lea Overby | Managing Director, CMBS Research and Analytics | Morningstar

Amid All the Noise, US CMBS Likely to Manage LIBOR's Swan Song with Minimal Disruption

In the aftermath of a rate fixing scandal, LIBOR, the underlying interest reference rate for $43.02 billion in loans backing US commercial mortgage-backed securities, is set to ride off into the sunset at the end of 2021. Benchmarks are arriving to take LIBOR's place around the world, and Morningstar Credit Ratings, LLC believes the new replacement rate for the United States will ultimately prove to be credit positive for the country's CMBS market. The Secured Overnight Financing Rate, or SOFR, is the recommended replacement rate of the Alternative Reference Rates Committee, or AARC, and debuted on April 3, 2018. Morningstar views this new rate to be more reliable because it is underpinned by considerably more transactions than LIBOR. SOFR is based on overnight repurchase agreements backed by Treasuries and, therefore, does not incorporate a credit stress component like LIBOR, so its risk-free status may have implications for spread volatility. Proper planning and preparation will be key in ensuring that the transition away from LIBOR will be smooth for the CMBS market.

CMBS Loans That Reference LIBOR

Table 1 illustrates the $43.02 billion in loans that collateralize US CMBS bonds tied to LIBOR by year of maturity as of April 1, 2018. The "pig in the python" year in terms of upcoming maturities is 2019, with 58.2% of the total. Short-term loan extensions of one year have been common in floating-rate loans tied to LIBOR, so we anticipate that the maturity data will change periodically.

TABLE 1

CMBS Loans Tied to LIBOR

Maturity Date	Loan Balance as of April 1, 2018 ($)	% of Total	# of Loans
2018 and Previously Matured	13,109,410,626	30.47	174
2019	25,019,712,677	58.16	111
2020	4,816,596,178	11.20	49
2021	66,435,791	0.15	2
2022 and After	7,476,128	0.02	6
Total	43,019,631,400	100.00	342

Sources: Trepp, Inc. and Morningstar Credit Ratings, LLC

As seen in the following table, the significant majority, or 52.9% of the total floating-rate debt exposure, is collateralized by hotels.

TABLE 2

CMBS Loans Tied to LIBOR by Collateral Type

Collateral Type	Loan Balance as of April 1, 2018 ($)	% of Total	# of Loans
Hotel	22,773,736,827	52.94	131
Office	6,890,781,533	16.02	56
Retail	5,927,034,776	13.78	66
Mixed Use	3,220,537,519	7.49	31
Industrial	1,706,762,550	3.97	11
Showroom	955,000,000	2.22	1
Multifamily	780,201,305	1.80	40
Healthcare	706,201,628	1.64	2
Other	59,375,260	0.14	4
Total	43,019,631,400	100.00	342

Sources: Trepp, Inc. and Morningstar Credit Ratings, LLC

Morningstar rated 35.7% of the total $43.02 billion of outstanding floating-rate debt, or $15.38 billion, as noted in Table 3 below. Of this amount, $13.75 billion, or 89.4%, matures in 2018 and 2019 or has already matured.

TABLE 3

CMBS Loans Tied to LIBOR in Transactions Rated by Morningstar

Maturity Date	Loan Balance as of April 1, 2018 ($)	% of Total	# of Loans
2018 and Previously Matured	7,277,329,228	47.32	77
2019	6,472,409,445	42.09	27
2020	1,580,000,000	10.27	3
2021	48,653,791	0.32	1
2022 and After	0	0.00	0
Total	15,378,392,464	100.00	108

Sources: Trepp, Inc. and Morningstar Credit Ratings, LLC

As seen in Table 4 below, of the collateral types in CMBS transactions that Morningstar has rated, hotels are predominant, at 42.4%, but less than the CMBS total of 52.9% noted in Table 2.

TABLE 4

CMBS Loans Tied to LIBOR Rated by Morningstar

Collateral Type	Loan Balance as of April 1, 2018 ($)	% of Total	# of Loans
Hotel	6,523,315,145	42.42	62
Office	3,076,718,919	20.01	15
Retail	2,367,900,431	15.40	16
Mixed Use	1,285,475,000	8.36	5
Showroom	955,000,000	6.21	1
Healthcare	706,201,628	4.59	2
Industrial	373,781,341	2.43	6
Multifamily	90,000,000	0.59	1
Total	15,378,392,464	100.00	108

Sources: Trepp, Inc. and Morningstar Credit Ratings, LLC

Why LIBOR is Being Phased Out

LIBOR has suffered from eroded confidence among market participants, both because of concerns about the fundamental lack of hard transactional data underpinning the rate and because of the 2012 rate fixing scandal. At their core, both issues are a function of the voluntary, survey-based methodology used to formulate LIBOR each business day. Largely a product of the birth of futures contracts used to hedge against interest-rate risk in the 1980s, LIBOR was originally overseen by the British Bankers Association (BBA). A panel of banks each submitted short-term rates for borrowing funds to the BBA. LIBOR provided a convenient standardized floating-rate benchmark with varying maturities and currency denominations.

In 2012, regulators discovered that members of the LIBOR bank panel had manipulated their submitted rates. Regulators in both the United Kingdom and the United States levied fines, and the BBA was forced to give up responsibility for setting the rate. Due diligence by the UK, US, and others revealed that the actual number of transactions occurring, which were the basis for the rate, was significantly lower than desirable. This immediately raised material credibility concerns. In the US, the Federal Reserve Board and the Federal Reserve Bank of New York convened the ARRC with the task of developing an alternative rate to LIBOR. Today, the UK's Financial Conduct Authority, or FCA, oversees LIBOR, and the Intercontinental Exchange (ICE) Benchmark Administration, an independent subsidiary of Intercontinental Exchange, administers it.

Panel banks may, but are not required, to submit their response to the following hypothetical question: "At what rate could you borrow funds were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 am London time?" Therefore, LIBOR can be characterized best as a survey-driven hypothetical rate, rather than a transaction-based rate. No new banks have joined the LIBOR panel for years, and because the banks perceive there to be an increasing level of regulatory risk from reporting without bona fide transactional data, it is highly unlikely any others will join. In a July 2017 speech, Andrew Bailey, the FCA's chief executive, raised doubts about the continued availability of LIBOR and noted that a significant amount of time was being spent persuading panel banks to continue submitting their short-term rates. Fundamentally, LIBOR suffers from a lack of market-based transaction data because fewer and fewer banks are engaging in interbank lending or borrowing activity.

On November 4, 2017, in remarks to the ARRC, then future Federal Reserve Chairman Jerome H. Powell stated, "For three-month funding … the most heavily referenced LIBOR tenor [although not in the CMBS market, which is one-month LIBOR], the median is less than $1 billion per day. On some days we see less than $100 million. If we compare this to the more than $100 trillion in outstanding volumes of US dollar LIBOR contracts, it should be clear that the activity in this market is minuscule compared to the size of the contracts written on it." The lack of transactional data underpinning the benchmark means that credit stress in the marketplace is reflected in the rate only if credit stress is incorporated into the panel banks' responses to the survey question.

The Early Days of the Phase-Out Process

The investor community has the opportunity now to define and address risks associated with retiring LIBOR so the unwind occurs in a timely, orderly fashion while minimizing uncertainty. Other markets such as credit default swaps and accompanying underlying collateral will likely need to transition first, given securitization is usually the last step in the commercial mortgage lifecycle. Regardless, Morningstar considers the following to be best practices in ensuring a smooth transition before the 2021 expiration date:

1) Review Existing Loan and Deal Documents

CMBS borrowers, servicers, and lenders need to prepare for upcoming maturities by reviewing loan documents early to determine the relevant interest-rate language regarding fallback reference rates. Fortunately, floating-rate loans are highly prepayable depending on property type, metrics, and other factors. The complication of defeasance, which is available for only fixed-rate loans, is a nonissue. It should be noted that some older loans (circa 2014 or before) do not necessarily allow for a change in the reference rate. Instead, the language for those loans indicates that they should convert to a fixed-rate coupon based on the last available LIBOR rate.

We reviewed the offering materials for JPMCC 2014-FL6 as an example of how loan and deal documents have addressed the possibility of LIBOR becoming unavailable. The offering circular for the deal says, in general terms, that if LIBOR cannot be determined, the loan documents allow for an alternative rate. Likewise, there are provisions for interest on the certificates to be calculated in an alternative manner.

A deeper dive into the offering materials sheds more light on these alternatives. If we use the pool's largest loan (Southland Mall) as an example, the loan's interest rate converts to one based on the prime rate in the event LIBOR cannot be determined. More specifically, there are provisions to calculate a prime rate spread as of the last date LIBOR was applicable to the loan. This prime rate spread is the non-negative difference between LIBOR plus the loan's spread and the prime rate as of the last day LIBOR was applicable. In equation form, it would be prime rate spread = (LIBOR + spread) - prime rate. To display how the unavailability of LIBOR would affect this loan, consider this example with the following variables: a LIBOR of 1.55947%, a spread of 2.9444%, and a prime rate of 4.50%. The loan's prime rate spread would be set at 0.00387% for the initial reset. This would then be added to the prime rate to calculate interest going forward, which would be 4.50387%. The effect on the interest rate would be minimal. This replacement index language is identical on other large loans we reviewed in the transaction.

Likewise, there are provisions for resetting the interest on the deal's certificates. The certificates have a similar mechanism for calculating a certificate prime rate spread, and the bonds then pay interest at the lesser of the prime rate plus the prime rate spread and the weighted average rate of the underlying mortgages (minus administrative costs). While we did not do an exhaustive review of offering documents, this is consistent with the language we've seen across other deals (COMM 2014-FL4 and MSCI 2015-XLF1).

One item of note is that while the loans have provisions for converting to a rate using the prime rate as the index, it is unknown if the LIBOR caps the loans are required to purchase have similar provisions. If there is no alternative to replicate the rate caps, and assuming the rate caps subsequently disappear, an environment of rising interest rates would increase debt service and increase default risk, especially on properties that have not yet stabilized. This could, in theory, result in ratings activity, especially at the bottom of the capital stack. However, Morningstar assumes a stressed interest rate on floating-rate loans using a fixed value of 3.50% or the actual rate cap, whichever is greater. Because our stressed rate is typically higher than the actual rate caps, our credit support levels already include sufficiently robust interest-rate assumptions.

While the planned retirement of LIBOR presents us with an array of interesting 'what-if' scenarios to contemplate, the actual event will likely be far less consequential. The actual impact on existing floating-rate CMBS deals would likely be immaterial. Because floating-rate loans typically have five-year terms (be it two years with three one-year extensions or three years with two one-year extensions), nearly every existing loan will be paid off (or, alternatively, with the special servicer) by the time LIBOR is retired. Newer deals already include adequate language to address the switch from LIBOR to an alternative rate. Therefore, while the broad impact on existing CMBS will be somewhat muted, there will likely be some individual loans that, based on performance and loan terms, could become interesting case studies as the retirement date nears.

2) Analyze Alternative Rates

The ARRC recommends SOFR, which is fully transaction based (at least $800.00 billion in daily transactions). The New York Fed began publishing SOFR on April 3, 2018, at an initial rate of 1.80%. In addition to the rate, the New York Fed will publish data summarizing the daily volume as well as the total amount of transactions used to calculate the rate. There is sufficient time to study the behavior and characteristics of SOFR in advance of year-end 2021.

Morningstar views SOFR's underlying transaction amount as robust and potentially credit positive for the CMBS market given the scope of underlying transactions and that the rate tracks closely with LIBOR over short- and long-term time frames. Because this rate lacks the credit stress component that applies to LIBOR, it may necessitate the need for a credit stress spread above SOFR that CMBS market participants will need to analyze. Also, LIBOR is a spectrum of rates that spans five different currencies and seven different maturities for a total of 35 rates per business day. The robust term structure created by the various maturities is enormously beneficial to market participants, and Morningstar believes this is one of the most important features likely to be sought in any replacement benchmark. In the US, the most commonly referenced term structure in CMBS collateral is one-month LIBOR. Of the floating-rate US CMBS loans that Morningstar analyzed, almost all are benchmarked to one-month LIBOR. SOFR does not yet provide a market for term loans such as one-month LIBOR, and a term loan market would have to be developed to facilitate comfortable implementation of SOFR.

3) Use CMBS Industry Initiatives

The CRE Finance Council, a trade group for the commercial real estate finance industry, has been drawing attention to the LIBOR issue and launched a task force in December 2015. Lisa Pendergast, executive director, later noted colorfully in a CREFC membership conference call on the issue that LIBOR represents "an elephant perched on a peanut" because of the low level of transactions associated with LIBOR. Among the issues that CREFC has highlighted was the necessity of publishing replacement rates as soon as possible so that market participants can sufficiently study potential reference rates. As noted earlier, SOFR was first published April 3. CREFC is also collaborating with other associations, including the International Swaps and Derivatives Association, and third-party counsel to develop new language in legal documentation concerning interest rates and replacement rates for the CMBS community, which could be adapted for individual loans.

Improved Risk Management in CMBS' Future

Although LIBOR could theoretically continue after 2021, the rate is unlikely to have any credibility at that point, and prudent risk management would dictate that no further CMBS floating-rate transactions should be tied to LIBOR. Morningstar anticipates several credit positive themes for CMBS despite the uncertainty that the potential dissolution of LIBOR provides. Among these are the opportunity to implement a credible replacement rate and improved CMBS risk management, including more thorough legal documentation regarding interest and replacement rates.

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CMBS – A Roundtable

October 9, 2018

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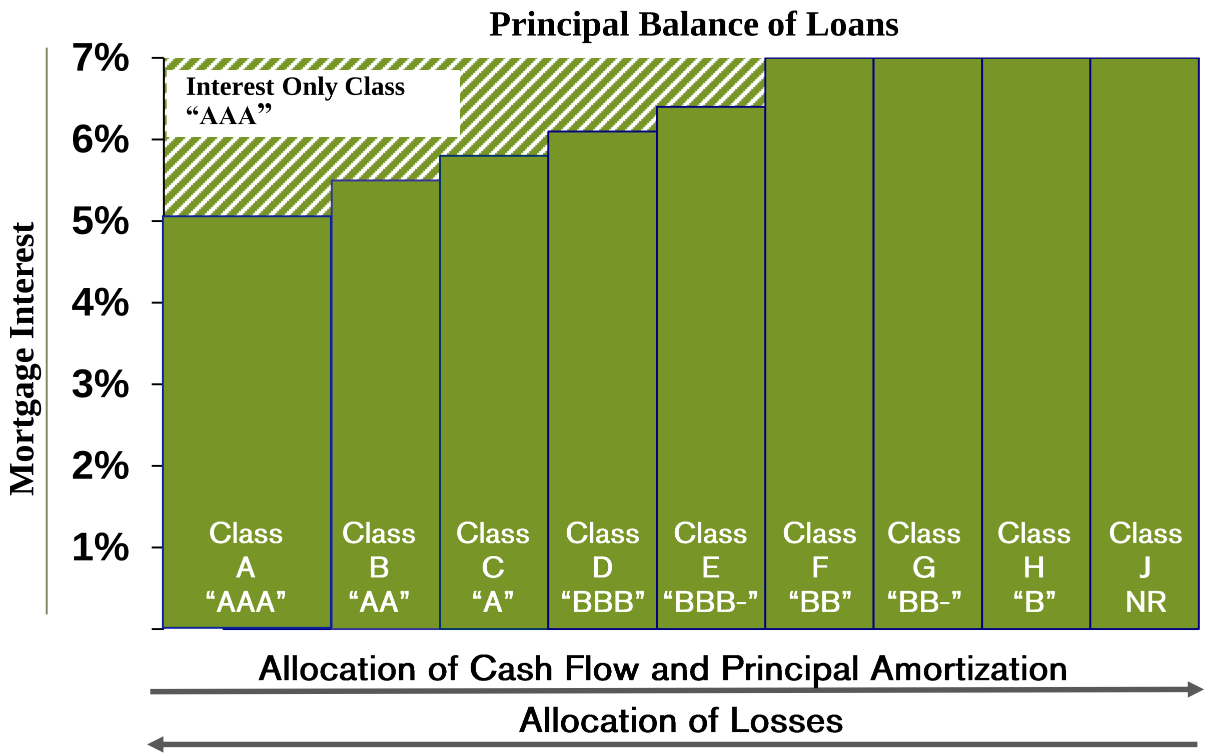
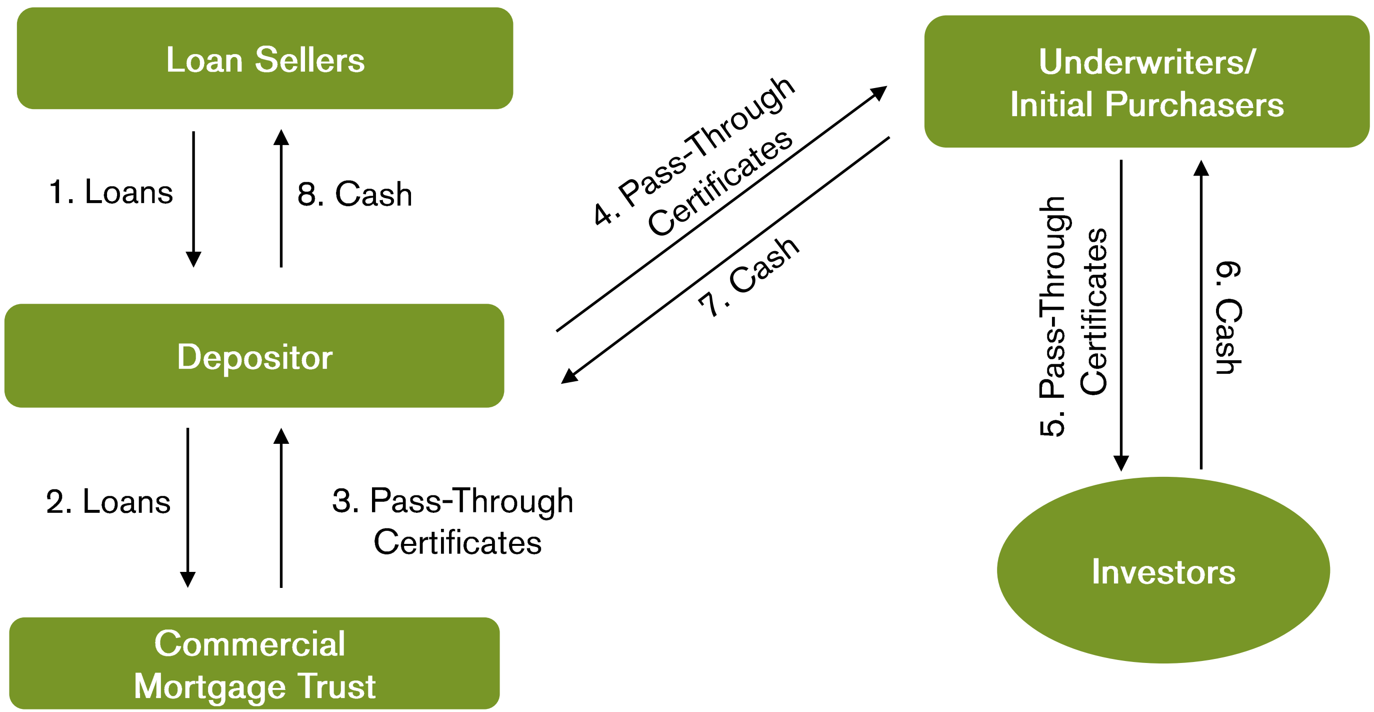
Typical CMBS Structure



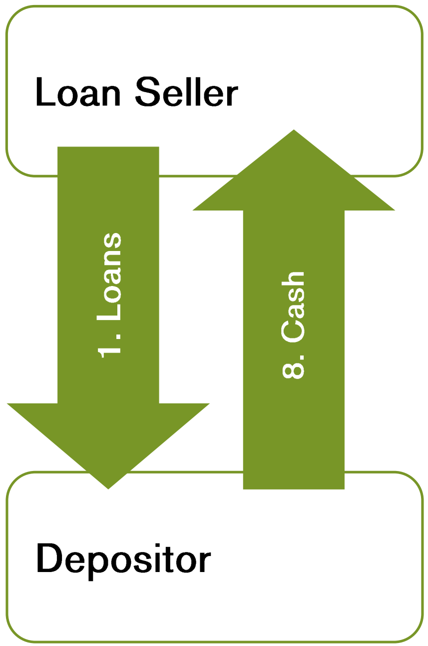
Allocation of Losses and Shortfalls

- Cashflow Applied Top-Down
  - “Waterfall”
- Losses Applied Bottom-Up
  - Realized Losses
  - Appraisal Reductions
    - Based on Updated Value of Property
    - Advances Will Be Reduced or Eliminated to Junior Classes
    - Primary Purpose Is to Prevent Controlling Class from Perpetually Extending Loans

Typical CMBS Structure



Typical CMBS Structure (Stage I)



LOAN SELLER

- Originates Commercial Mortgage Loans

DEPOSITOR

- Special Purpose Corporation That Buys Loans and Deposits into Securitization Trusts

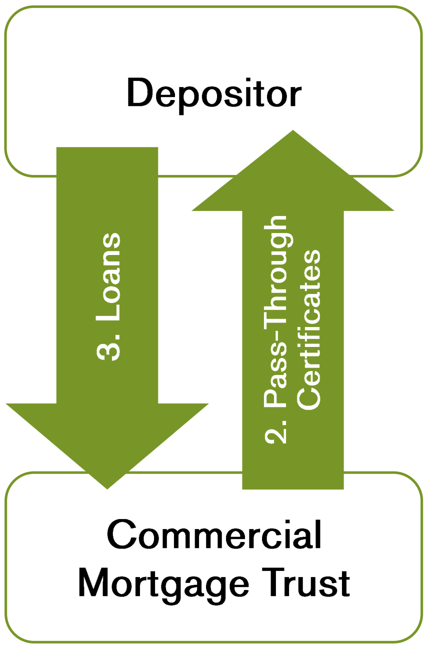
Mortgage Loan Purchase Agreement

- Conveys Loans to Depositor
- Representations and Warranties
  - Made by Seller to Depositor Regarding Loans
  - Due Diligence to Verify Accuracy, Disclose Exceptions
- Delivery of Complete Loan Files
  - Document Defects

Mortgage Loan Purchase Agreement (cont'd)

- Buy-Back Obligations
  - Material Breach of Representation or Material Document Defect
    - Seller Will Have Limited Time to Cure
    - Failure to Cure Requires Repurchase

Typical CMBS Structure (Stage II)



POOLING AND SERVICING AGREEMENT

- Depositor
- Trustee
- Master Servicer
- Special Servicer
- Operating Advisor

Pooling and Servicing Agreement

- Transfers Loans from Depositor to Trust
- Assigns Representations and Warranties to Trustee
- Servicing of Loans and Properties
- Issuance of Certificates
- Payments and Reporting to Investors

Pooling and Servicing Agreement (cont'd)

- Trustee
  - Acts as Representative of Certificateholders
  - Beneficiary of Loan Seller Representations
  - Makes Distributions to Investors
  - Provides Reports to Investors
  - Custodian of Loan Documents

Pooling and Servicing Agreement (cont'd)

- Master Servicer
  - Oversees Any Primary Servicers
  - Collects Loan Payments on Loans (or from Primary Servicers) and Remits to Trustee
  - Prepares Monthly Reports
  - Responsible for Advancing of Delinquent Payments
    - Debt Service (Subject to Appraisal Reductions)
    - Property Protection Advances (Tax, Insurance, Emergency Repairs, etc.)
- Primary Servicer
  - Collects Payments on Loans
  - Primary Contact for Borrowers
  - Prepares Loan and Property-Level Reports
  - Monitors Tax and Insurance Payments

Pooling and Servicing Agreement (cont'd)

- Special Servicer
  - Responsible for Servicing of Troubled Loans
    - Loans Delinquent for 60 Days or More
    - Loans Where Balloon Payment Is Not Made
    - Borrower Bankruptcy
    - Certain Other Events
  - Responsible for "Working-Out" Mortgage Loans with Borrowers, Selling Defaulted Mortgage Loans or Foreclosing on Mortgaged Properties
  - Responsible for Managing and Liquidating Property When the Trust Has Foreclosed

Pooling and Servicing Agreement (cont'd)

- Operating Advisor
  - Annual Reviews of Servicer
  - After Control Change:
    - Consulting With Respect to Major Decision
    - Can Recommend Replacement of Special Servicer

Pooling and Servicing Agreement (cont'd)

- Controlling Class of Certificateholders
  - Typically Most Junior Class
  - Allocated Losses First
  - Can Appoint Special Servicer
  - Consent and/or Consultation Rights to Loan Modifications and Workout and Foreclosure Actions
- Rating Agencies
  - Securities Must Achieve Specified Ratings
  - Review Loans and Bond Structure on Behalf of Investors
  - Monitor Deals on Ongoing Basis

Typical CMBS Structure (Stage III)

- **Underwriting or Certificate Purchase Agreement**

Typical CMBS Structure (Stage IV)

- Dissemination of Prospectus / Offering Circular to Investors
- Dissemination of Term Sheet to Investors
- Trade Confirmations